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In the Supreme Court of the United States

OCTOBER TERM, 1987

THE VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, RESPONDENT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED

Whether a traditional fixed annuity that is subject to extensive regulation by state insurance commissioners is a "security" within the meaning of the federal securities laws because it also includes a discretionary "excess interest" component.

PARTIES TO THE PROCEEDING AND RULE 28.1 STATEMENT

Petitioners, who were defendants and appellees in the courts below, are The Variable Annuity Life Insurance Company (VALIC), Charles T. Bauer, Mortimer M. Caplin, Henry Chauncey, Harry C. Copeland, Jr., W. Thomas Fiquest, Frederick M. Glass, Grinnel Morris, Roy T. Parker, Jr., Robert S. Phillips, Michael E. Puyans, W. Dawson Sterling, Benjamin N. Woodson, Philip G. Davidson III, Andrew Delaney, Joe F. Flack, Richard H. Hanneman, Harold S. Hook, George F. Reed, Robert L. Baldwin, Stephen D. Bickel, Terrence J. Conlan, Joe D. Heusi, John D. Hogan, William B. Pardue, William B. Phelps, Michael J. Poulos, Robert O. Purcifull, Diane G. D'Agostino, Gregory C. Wilcox, The Variable Annuity Marketing Company (VAMCO), The Variable Annuity Life Insurance Company Separate Account One, and American General Corporation. American General Corporation indirectly owns all of the stock of VALIC; VAMCO is a wholly-owned subsidiary of VALIC. The subsidiaries owned by American General Corporation, and the joint ventures in which they are involved, are listed in App., *infra*, 65a-67a.

Respondent Beverly J. Otto was the named plaintiff in the district court and the appellant in the court of appeals. She was certified by the district court as the representative of a class consisting of all Illinois participants in the fixed annuity program of The Variable Annuity Life Insurance Company between October 17, 1975, and August 2, 1982 (App., *infra*, 3a).

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Variable Annuity Life Insurance Company, *et al.*, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The original opinion of the court of appeals (App., *infra*, 1a-25a), its opinion on rehearing (App., *infra*, 26a-32a), and its order amending its opinion on rehearing (App., *infra*, 33a-34a) are reported at 814 F.2d 1127. The opinion of the district court granting summary judgment to petitioners on respondent's federal securities claim (App., *infra*, 35a-47a) is reported at 611 F. Supp. 83. The opinion of the district court denying respondent's motion for reconsideration (App., *infra*, 48a-56a) is reported at 107 F.R.D. 635.

JURISDICTION

The judgment of the court of appeals was entered on April 15, 1987 (App., *infra*, 57a-58a). A petition for rehearing was denied on June 15, 1987 (App., *infra*, 59a). On August 28, 1987, Justice Stevens granted an extension of time to and including October 13, 1987, within which to file a petition for a writ of certiorari (App., *infra*, 64a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 3(a)(8) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(8), Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), Sections 1 and 2 of the McCarran-Ferguson Act, 15 U.S.C. §§ 1011 and 1012, and SEC Rule 151, 17 C.F.R. § 230.151, are set forth at App., *infra*, 60a-63a.

STATEMENT

This case involves a fixed annuity sold by petitioner The Variable Annuity Life Insurance Company (VALIC). Annuities provide benefits for the life of the annuitant; just as life insurance protects against the risk of premature death, an annuity protects against the risk that the policyholder will exceed his actuarially-determined life expectancy and thereby outlive his accumulated savings.

Annuities traditionally have been regarded as insurance products and are extensively regulated by state insurance commissioners. Concomitantly, federal law excludes annuities from the scope of the securities acts. While some instruments denominated as "variable annuities" have been held to be a "security" because they have the essential elements of an equity investment, fixed annuities have been widely understood to be insurance and not a "security." The decision below represents the first time that a fixed annuity has been held to be subject to the federal securities laws.

A. VALIC's Fixed Annuity.

VALIC, a Texas stock insurance company authorized to do business in all 50 states and the District of Columbia, sells annuities that qualify for special tax benefits under Section 403(b) of the Internal Revenue Code (26 U.S.C. § 403(b)). During the period at issue, VALIC offered two types of annuities: variable and fixed. Under the variable annuity, VALIC did not guarantee either the principal or the rate of return. Rather, the funds related to this annuity were placed in a Separate Account that was segregated from VALIC's general assets and invested in a diversified portfolio of common stocks and other equity-type investments. The value of the variable annuity was solely a function of the success of the investments in the Separate Account. App., *infra*, 9a.

VALIC's variable annuity was largely designed as a hedge against inflation over the period of the annuity contract. VALIC (through a wholly-owned subsidiary) marketed the variable annuity on the basis of long-term capital appreciation, and its literature made clear the nature of this type of annuity and the benefits and risks that it entailed. The variable annuity was registered as a security under the Securities Act of 1933, 15 U.S.C. § 77f, and the Separate Account was registered as an investment company under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 *et seq.* Furthermore, VALIC's subsidiary was registered as a "broker/dealer," and the agents who sold the variable annuity were registered as National Association of Securities Dealers (NASD) representatives. App., *infra*, 38a.

Beginning in 1964, VALIC also offered a fixed annuity, which guaranteed that not less than all principal (premium payments), accumulated at a specified minimum rate of interest, would be applied to the purchase of an annuity at actuarially-determined rates. VALIC's fixed annuity paid 4% interest per year for the first 10 years

and 3½% interest annually thereafter. In contrast to the variable annuity, VALIC's promotional materials explained and emphasized the conservative nature of the fixed annuity. App., *infra*, 3a, 7a.

In addition to the guaranteed payment of both principal and specified interest, VALIC's fixed annuity provided that the company could, at its option, pay so-called "excess interest"—interest above the rate guaranteed in the policy. Whether to declare "excess interest" and in what amount were entirely within the discretion of VALIC; annuitants had no entitlement to or assurance of the provision of "excess interest" benefits. On the other hand, once an "excess interest" payment was declared and credited to an annuitant's account, it was vested and could not be taken away. App., *infra*, 30a.

Fixed annuity funds were included in VALIC's general assets and invested, pursuant to state insurance law requirements, in long-term debt-type instruments such as mortgages and bonds. The fixed annuity was not registered under the Securities Act, nor was VALIC registered as a "broker/dealer" or an investment company. Likewise, to sell this policy, VALIC's agents were not required to be registered as NASD representatives and had to be licensed only by state insurance departments. App., *infra*, 8a, 38a.

B. The Proceedings Below.

1. Respondent is the representative of a class of all Illinois participants in VALIC's fixed annuity program between October 17, 1975, and August 2, 1982 (App., *infra*, 3a). She brought this action in the United States District Court for the Northern District of Illinois on August 2, 1982, alleging that VALIC's fixed annuity was a "security" and that VALIC had violated Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j (b)) and SEC Rule 10b-5 thereunder (17 C.F.R.

§ 240.10b-5).[1] Specifically, respondent contended that VALIC failed to disclose the method it used to calculate the applicable discretionary "excess interest" payments. App., *infra*, 36a.

The district court granted summary judgment to petitioners, holding that the fixed annuity was not a "security" (App., *infra*, 36a-42a). Relying primarily on this Court's decisions in *SEC* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (*VALIC I*), and *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), the district court concluded that the fixed annuity was "more properly viewed as an insurance product than as an investment contract" and therefore was outside the scope of the federal securities laws (App., *infra*, 37a).

In reaching this conclusion, the district court determined that the company "bears the investment risk" in the fixed annuity because it "guarantee[s] the return of the participants' contributions plus interest," and that "the economic inducement is indeed the 'usual insurance basis of stability and security' rather than growth through investment" (App., *infra*, 40a). In particular, the district court rejected respondent's argument that "the guaranteed rates of interest were hardly enough to attract anyone to the contract and that the incentive was the discretionary interest payable." *Id.* at 41a n.5. The court also referred to a letter sent to annuity issuers by the Securities and Exchange Commission, which stated that "neither the [issuer's] general account nor any interests therein are generally subject to the provisions of the 1933 or 1940 Acts" (*id.* at 42a & n.6).

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[1] Respondent also included counts against VALIC under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001 *et seq.*, the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961 *et seq.*, and state law. Those counts were dismissed by the courts below and are not involved in this petition.

2.a. On respondent's appeal, the Seventh Circuit initially affirmed the district court's holding that VALIC's fixed annuity was not a security (App., *infra*, 5a-13a). Applying the analysis of *VALIC I* and *United Benefit*, the court of appeals held that VALIC's fixed annuity fell within Section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. § 77c(a)(8)), which excludes from the federal securities laws "[a]ny insurance or endowment policy or annuity contract or optional annuity contract."

The court of appeals first explained that VALIC had guaranteed principal and interest on the fixed annuity "[r]egardless of the investment success" of the company or general "economic conditions" (App., *infra*, 9a). Moreover, funds related to the fixed annuity "were mingled with the company's general assets" rather than maintained in a separate account and were "invested primarily in debt-type securities" (*ibid.*). And "VALIC promoted its fixed annuity as insurance" and designed it to provide "a long-term accumulation of funds for retirement through compound interest" (*ibid.*). Thus, the Seventh Circuit held that VALIC's fixed annuity possessed the customary features of an annuity and "appealed to potential participants on the usual insurance bases of stability and security" (*id.* at 8a).

The court of appeals expressly rejected respondent's contention that the guaranteed rate of interest under the fixed annuity (4% per year for the first 10 years and 3½% per year thereafter) was so minimal that it left the investment risk on the participant and imposed no significant investment risk on VALIC. The court explained that, although the rate was low, "it was not so low that we can say it placed the investment risk on the policyholder in a way substantial enough to make the fixed annuity a security" (App., *infra*, 9a).

Finally, the court of appeals noted that its decision was "supported" by the recently released SEC Rule 151,

17 C.F.R. § 230.151, 51 Fed. Reg. 20,254 (June 4, 1986), which provides certain annuities with a "safe harbor" exclusion from the federal securities laws (App., *infra*, 10a).[2] The court remarked that "VALIC's fixed annuity satisfies all of the requirements of Rule 151" (*id.* at 12a) because VALIC was subject to the supervision of state insurance commissioners, because the fixed annuity was not marketed primarily as an investment, and because VALIC assumed the investment risk by guaranteeing principal and specified interest payments and by agreeing not to modify the "excess interest" rate more frequently than once per year. *Id.* at 12a-13a.

b. Respondent sought rehearing of the court of appeals' decision. In addition, petitioners moved to modify the opinion on the ground that the court had been mistaken in assuming that VALIC's fixed annuity satisfied the requirement of Rule 151 that the insurer agree not to modify the "excess interest" rate more often than once a year. Although VALIC in fact had not changed the rate of "excess interest" on existing deposits at any time during the relevant period, it had the discretion to do so (on a prospective basis) and therefore did not meet this provision of the "safe harbor" rule.

Following supplemental briefing, the court of appeals granted rehearing and reversed its prior decision, holding that VALIC's fixed annuity *was* a "security" and thus was subject to the federal securities laws (App., *infra*, 26a-32a).[3] The panel made virtually no attempt to rec-

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[2] Rule 151 took effect on June 4, 1986, and therefore was not directly applicable to the period at issue in this litigation.

[3] The court of appeals suggested that VALIC had failed initially to make clear that its fixed annuity did not satisfy the one-year "excess interest" requirement of Rule 151 (App., *infra*, 28a). While not material to the question presented in this Petition, we do note, for the reasons fully explained by VALIC in its briefs below, that the terms and operation of the "excess interest" provision were accurately and sufficiently described in VALIC's sub-

oncile this about-face with its previous analysis or to explain why, apart from the SEC's "safe harbor" rule, the fixed annuity constituted a "security" under the statutes and the decisions of this Court. Instead, it rested its revised ruling entirely on the fact that the "excess interest" rate was not guaranteed to remain unchanged for at least a year—a factor, the court acknowledged, that had never been "relied on previously in court decisions distinguishing securities from insurance products" (*id.* at 31a). Accordingly, while purporting to recognize that SEC Rule 151 is a "safe harbor" provision rather than a definitional standard for the term "security" (*ibid.*), the court held that VALIC's fixed annuity was a "security" because it did not meet one of the elements of the Rule.

REASONS FOR GRANTING THE PETITION

Under longstanding principles of federalism, and pursuant to express statutory provision, insurance and annuities have been excluded from the scope of the federal securities laws and instead have been subject to the exclusive regulation of the states. As recognized by both the district court and the court of appeals in its original opinion, VALIC's fixed annuity bore the essential characteristics of an excluded "annuity" rather than a covered "security" within the meaning of federal law. Nonetheless, the Seventh Circuit concluded on rehearing that the fixed annuity was a security simply because it failed to satisfy one of the requirements of the SEC's rule for a "safe harbor" exemption from the securities laws.

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missions to the court. Indeed, the court of appeals, in its opinion on rehearing, recognized that VALIC's opening brief had argued only that the fixed annuity "'*largely* satisfies'" Rule 151 (*id.* at 29a (emphasis added)), and the district court's opinion expressly noted that "the discretionary interest, of course, was just that—discretionary—and could be varied or omitted at any time" (App., *infra*, 41a n.5). Moreover, VALIC itself pointed out the court of appeals' error by moving to modify the original opinion.

The court of appeals' erroneous ruling threatens to have immediate and severe consequences for the insurance industry and state insurance commissioners. Insurance companies, which have predicated their fixed annuity businesses on the understanding that they were not covered by the federal securities laws, suddenly find themselves exposed to enormous potential liability and ongoing regulation under those laws. Furthermore, it would be inconsistent with the scheme of exclusive state authority over the business of insurance for the SEC and federal courts (and juries) now to superimpose federal requirements on state insurance systems. Such drastic results should not be permitted to occur based on the decision of a single court of appeals.

Indeed, for insurance companies that sell annuities in states within the Seventh Circuit, the ruling below is effectively of nationwide scope. Compliance with most of the requirements of the federal securities laws—such as the various registration requirements for securities, for "broker/dealers," and for investment companies—can occur only on a national basis; if, for example, VALIC and other companies must register their fixed annuities as "securities" under the Securities Act of 1933 in order to do business in Illinois, Wisconsin and Indiana, that registration will cover all such annuities regardless of where they are sold in the United States. For these companies, therefore, the decision of the court of appeals has substantially the same effect as a decision of this Court: it is, as a practical matter, binding everywhere, not just in the states that the Seventh Circuit comprises.

In *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 207 (1967), the Court granted certiorari to decide whether a particular annuity was a "security" because of "the importance of the issue" and "the need for clarifying the implications" of the seminal decision in *SEC* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65

(1959) (*VALIC I*).[4] Precisely the same considerations warrant further review here.

A. The Court Of Appeals' Decision Will Have Immediate And Widespread Consequences That Will Adversely Affect The Insurance Industry, State Insurance Commissioners, The SEC, And Policyholders.

The court of appeals has held that a traditional insurance product, the fixed annuity, is in fact a "security" subject to the myriad requirements of the federal securities laws. This decision, if allowed to stand, will have widespread adverse consequences for the insurance industry, state insurance commissioners, the SEC, and policyholders. These regulatory burdens and economic dislocations should not be permitted to occur unless and until this Court rules that federal law requires such results.

The Seventh Circuit's decision is of enormous concern to a major segment of the insurance industry. As the American Council of Life Insurance (ACLI) explained in its brief (at 1 (emphasis added)) as *amicus curiae* in support of rehearing en banc in the court below:

> Most fixed-dollar annuity contracts and some forms of fixed-dollar life insurance (*e.g.*, universal life insurance) contain guarantees of principal and interest and "excess interest" features that have varying degrees of similarity to the guaranteed and excess interest provisions of the fixed annuity contract issued by [VALIC]. These contracts represent *a significant portion of the aggregate life in-*

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[4] As Professor Loss has explained, the analytical "difficulty" in this area of the law is that insurance and annuity plans lie along "a continuous spectrum"—from "pure insurance" on one side to "pure investment" on the other. L. Loss, *Fundamentals of Securities Regulation* 224 (1983). Annuities that are "in varying degrees * * * variable" (*ibid.*) fall between those poles.

surance and annuity business in force in the United States today.

In 1985, 10 million fixed-dollar individual annuities, involving $24 billion in present and deferred annual annuity payments, were outstanding. See American Council of Life Insurance, *Life Insurance Fact Book—1986*, at 39. Moreover, 33 million people were covered under private pension plans funded by fixed-dollar group annuity contracts; these plans received $35 billion in contributions during that year and paid out benefits of $10 billion. *Id.* at 57. And there were also 7 million universal life policies in force, representing $564 billion of insurance. *Id.* at 29.

As ACLI's *amicus curiae* brief pointed out (at 9, 12 (emphasis added)), a large number of these annuity (and insurance) policies do not qualify for "safe harbor" treatment under SEC Rule 151:

> At the time that Rule 151 was adopted, * * * *both the industry and the Commission understood that many annuity contracts (and all life insurance contracts) would fall outside the safe harbor for one or more reasons.*
>
> * * * * * *
>
> In commenting on proposed Rule 151, the Council advised the Commission that several aspects of the proposal, including the investment risk standards, would, if adopted, compel most issuers of fixed annuities to rely directly upon the statutory exclusion in Section 3(a)(8) rather than seek the added regulatory comfort afforded by Rule 151. Inasmuch as the rule was adopted in substantially the same form in which it was proposed, *most issuers of fixed annuity contracts have, in fact, elected to remain outside the safe harbor.*

Thus, a substantial portion of the insurance industry has been thrown into jeopardy and confusion by the deci-

sion below. The industry has sold millions of policies on the understanding that fixed annuities like VALIC's are not subject to the federal securities laws. That reasonable business expectation—which is of "vital" importance to the insurance industry's ability to project liabilities and risks (see *Allied Structural Steel Co.* v. *Spannaus*, 438 U.S. 234, 246-247 (1978))—should not be lightly and precipitously upset. See, *e.g.*, *FDIC* v. *Philadelphia Gear Corp.*, 106 S. Ct. 1931, 1938 (1986); *BankAmerica Corp.* v. *United States*, 462 U.S. 122, 130-133 (1983).

For the insurance industry, the changes required under the court of appeals' decision will be far-reaching and immediate. An insurance product marketed nationwide, such as VALIC's fixed annuity, plainly cannot be treated as a "security" solely within the Seventh Circuit. Therefore, unless insurance companies were simply to cease doing business within the Seventh Circuit, which is not a feasible option, they will have to comply with this decision across the United States.

If "excess interest" annuities are securities, they will have to be registered under the Securities Act of 1933, 15 U.S.C. §§ 77e *et seq.* Insurance companies and their agents will have to qualify as "broker/dealers" and NASD representatives under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(a)(4)-(5), 78o. And the companies also might have to conform to the requirements of the Investment Company Act of 1940 (see 15 U.S.C. §§ 80a-2(a)(17), 80a-3(a) & (c)(3)), which would necessitate significant changes in the corporate structure and business practices of the companies and burden the sale of these annuities.

Moreover, insurance companies will be exposed to potential retroactive liabilities of enormous proportion. As this case illustrates, the decision below encourages multi-

year class actions seeking substantial damages based on the alleged failure of insurance companies to comply with federal securities provisions that they quite reasonably understood not to apply to their sale of annuities. In addition, Section 12(1) of the 1933 Act (15 U.S.C. § 77*l*(1)) imposes absolute liability for the sale of unregistered "securities" and entitles a purchaser to seek rescission plus interest; such relief would nullify the actuarial determinations and risk-pooling arrangements on which the annuity plan was based. And the Investment Company Act provides that if the issuing firm is found to be an unregistered "investment company," its sales of the annuity—indeed, all of its securities transactions in managing its portfolio of general assets—would be illegal as a matter of federal law. See 15 U.S.C. §§ 80a-7, 80a-46(b).

The court of appeals' ruling also dramatically and directly implicates the interests of the state and federal governments. As discussed in more detail below (see pages 24-28, *infra*), application of the federal securities laws to VALIC's fixed annuity and similar products will interfere with the exclusive authority of state insurance commissioners over the business of insurance. By the same token, as companies issuing this type of annuity seek to comply with the applicable registration requirements for "securities," for "broker/dealers," and for "investment companies," the SEC will be confronted with a significant and unanticipated demand on its limited regulatory resources.

Finally, the Seventh Circuit's decision will impair the interests of annuity policyholders. The court's ruling will unquestionably increase insurance companies' costs of doing business, which will make annuities more expensive for consumers and limit the availability of these policies. Furthermore, if fixed annuities are "securities," they might no longer be covered by state insurance guaranty funds, which protect policyholders in the event an

insurance company becomes insolvent (see page 27, *infra*). On the other hand, the court's extension of the federal securities laws to fixed annuities will provide policyholders with little if any additional protection from fraud, since state law already prohibits false and misleading statements by insurance companies (see page 25, *infra*).

Given the nature of the insurance business and the comprehensiveness of the federal securities laws, the court of appeals' decision will have a permanent, immediate, nationwide impact. Accordingly, this Court's review is essential to restore the balance between the state and federal regulatory schemes that has been disrupted by the decision below—a decision that, as we now discuss, is plainly incorrect.

B. The Court Of Appeals Erred In Holding That VALIC's Fixed Annuity Was A "Security" Subject To The Federal Securities Laws.

The applicability of the Securities Act of 1933 and the Securities Exchange Act of 1934 depends upon the term "security." [5] For two reasons, VALIC's fixed annuity was not a "security" under those Acts.

First, Section 3(a)(8) of the 1933 Act excludes from the securities laws "[a]ny insurance or endowment policy or annuity contract or optional annuity contract" issued by a corporation subject to the supervision of the

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[5] See Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10); see also Investment Company Act of 1940, § 2(a)(36), 15 U.S.C. § 80a-2(a)(36). This Court has "repeatedly ruled that the definitions of 'security' in § 3(a)(10) of the 1934 Act and § 2(1) of the 1933 Act are virtually identical and will be treated as such in our decisions dealing with the scope of the term." *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 686 n.1 (1985).

insurance commissioner of any state.[6] Moreover, this specific exemption is reinforced by the McCarran-Ferguson Act, 15 U.S.C. §§ 1011 *et seq.*, which establishes exclusive state regulation of the business of insurance. Thus, however broad the definition of "security" may be in general (see, *e.g.*, *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 686 (1985)), it does not extend to products with the attributes of an insurance policy or annuity contract.

Second, this Court's recent decisions establish that "Congress did not intend [the securities laws] to provide a comprehensive federal remedy for all fraud." *Landreth*, 471 U.S. at 687-688; see also *Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 478-480 (1977). Rather, in defining the term "security," the Court has been mindful that the securities laws should not be applied in a manner that would disrupt or intrude upon alternative regulatory systems. See *Marine Bank*, 455 U.S. at 557-559; *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551, 569-570 (1979). And this concern is particularly significant where the "extension of the federal securities laws would overlap and quite possibly interfere with state * * * law" (*Green*, 430 U.S. at 479). Here, application of the federal securities laws would directly and substantially interfere with the exclusive state regulation of insurance.

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[6] This Court, the SEC, and commentators have recognized that Section 3(a)(8) of the 1933 Act, while literally drafted as an exemption from the provisions of that statute, more broadly excludes insurance and annuities from the "securities" that are subject to the 1933 and 1934 Acts. See *Tcherepnin* v. *Knight*, 389 U.S. 332, 342 n.30 (1967); H.R. Rep. No. 85, 73d Cong., 1st Sess. 5, 15 (1933); SEC Release 33-6558, 49 Fed. Reg. 46,750, 46,753 (Nov. 28, 1984); L. Loss, *Fundamentals of Securities Regulation* 214 (1983).

1. *VALIC's Fixed Annuity Was An "Annuity" Rather Than A "Security" Under* VALIC I *And* United Benefit.

Although the federal securities laws exclude from their coverage any "annuity contract," this Court has held that some annuities are sufficiently similar to an equity investment (such as a mutual fund) that they constitute a "security." The Court's analysis in those cases demonstrates that VALIC's fixed annuity is a true "annuity" that is exempt from the securities acts.

In *VALIC I*, the Court held, 5-4, that VALIC's variable annuity was a "security" under the federal securities laws. The variable annuity did not guarantee either principal or interest, and the annuity premiums were pooled and placed in equity investments. Accordingly, the policyholders had "nothing * * * except an interest in a portfolio of common stocks or other equities" (359 U.S. at 72), and the benefit payments to which they were entitled "var[ied] with the success of the investment policy" (*id.* at 69).

The Court agreed that VALIC had assumed a mortality risk under the policy, which was one of the two requirements of an exempt annuity (359 U.S. at 70). However, it concluded that the second requirement—the company's assumption of an investment risk—was not satisfied because benefit payments depended entirely on the success of the equity portfolio and included no guaranteed fixed income (*id.* at 71-73):

> The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. * * * But * * * the concept of "insurance" involves some investment risk-taking on the part of the company. * * * "[I]nsurance" involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts.

Given these characteristics, the variable annuity involved "a very substantial and in fact predominant element of the business of an investment company * * * [that is] totally foreign to the business of a traditional life insurance and annuity company, as traditionally regulated by state law" (*id.* at 81 (Brennan, J., concurring)).

In *United Benefit*, the Court held that a deferred or optional "flexible fund" annuity was a "security." In that case, the annuity premiums were maintained in a separate account, segregated from the insurer's general assets, that was invested in common stocks to produce capital gains. Each policyholder had a proportionate share in the separate account, and benefits were a function of the investment success of the fund; however, the company also guaranteed a minimum alternative cash value based on a percentage of net premiums (*i.e.*, premiums less specified deductions). The company advertised that the annuity provided "a chance to share in the growth of the country's economy" by reaping the benefits of a professional investment program. See 387 U.S. at 204-206 & n.3.

Because of the operation of the deferred annuity, the Court held that the "pay in" portion of the contract could be separated from the "pay out" portion and that the former was a covered "security" rather than an exempt "annuity." The Court found that the company did not bear a mortality risk under the "pay in" part of the policy (387 U.S. at 211) and that the annuity "appeal[ed] to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management" (*ibid.*). Given these findings, the Court concluded that the existence of a guaranteed cash value—which in fact represented a minimal guarantee that was unlikely to come into operation (*id.* at 208-209 & nn. 10, 12)[7]—did not

[7] Among other things, the cash value guarantee in *United Benefit* neither ensured *any* return on the investment nor protected

"by itself" convert the contract from a "security" into an "annuity" (*id.* at 211).

In the present case, the Seventh Circuit did not hold that VALIC's fixed annuity failed to meet the criteria of an "annuity" laid down in *VALIC I* and *United Benefit*. Thus, the court of appeals did not dispute that VALIC assumed a mortality risk under the annuity contract. Nor did it conclude that VALIC was not bearing a substantial investment risk; on the contrary, the court noted that the express guarantee of principal and specified interest regardless of investment success or economic conditions entailed a significant investment risk (App., *infra*, 8a-9a).[8] Likewise, the court found that VALIC's fixed annuity rested "on the usual insurance bases of stability and security" (*id.* at 8a) and that VALIC "promoted its fixed annuity as insurance" with the objective of "a long-term accumulation of funds for retirement through compound interest" (*ibid.*). Finally, the court acknowledged that premiums for the fixed annuity "were mingled with the company's general assets," rather than segregated in a separate fund, and were "invested primarily in debt-type securities" (*ibid.*).

In light of these determinations, it is apparent that VALIC's fixed annuity had the essential characteristics of a traditional insurance product as set forth in this

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against the outright loss of a significant portion of principal. In this case, by contrast, VALIC's fixed annuity guaranteed both principal in full and a specified rate of return. App., *infra*, 38a.

[8] By setting the maximum interest rate an insurance company may assume in establishing reserves for annuity contracts, state insurance laws effectively regulate the maximum interest rate that may be guaranteed under a fixed annuity. See, *e.g.*, Ill. Rev. Stat. ch. 73, § 835 (1985); Tex. Ins. Code Ann. § 3.28 (Vernon 1981). Such a limitation ensures that the guaranteed rate does not exceed what can be safely and reliably maintained over the life of the annuity. The fact that fixed annuities guarantee interest that is below market rates of return is thus an integral feature of this insurance product.

Court's decisions. Because of the guarantee of principal and specified interest, the annuity policy satisfied the "concept of 'insurance,'" which requires that there be "some investment risk-taking on the part of the company" and payment of "at least some fraction of the benefits * * * in fixed amounts" (*VALIC I*, 359 U.S. at 71). Unlike the variable annuity in *VALIC I*, the fixed annuity policy represented a "true underwriting of risks" (*id.* at 73). The Seventh Circuit therefore was plainly wrong in concluding that, despite these attributes, the fixed annuity contract was transformed into a "security" simply because of the existence of the discretionary "excess interest" provision—an element, as the court below candidly conceded, that has not been "relied on previously in court decisions distinguishing securities from insurance products" (App., *infra*, 31a).[9]

Because fixed annuities that guarantee principal and a specified return without "excess interest" are rarely sold in the market today, the "excess interest" fixed annuity is the closest available type of policy to the paradigm of a fixed annuity that Congress clearly intended to be excluded from federal securities regulation. The court of appeals' expansion of the securities laws to apply to "excess interest" fixed annuities thus is wholly at odds with the admonition in *VALIC I* that courts should not "freeze the concepts of 'insurance' or 'annuity' into the mold they fitted when these Federal [Securities] Acts were passed." 359 U.S. at 71; see also *id.* at 76 (Brennan, J., concurring); *id.* at 101 (Harlan, J., dissenting).

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[9] See Kroll and Cohen, *The Insurance-Security Identity Crisis*, 46 Geo. Wash. L. Rev. 790, 794, 801-805 (1978); Recent Decisions, 61 Mich. L. Rev. 1374, 1381 (1963); Annotation, *What Annuity Contracts are Subject to Securities Act of 1933—Federal Cases*, 18 L.Ed.2d 1557, 1560 (1967). See also Fleming, *Universal Life: Finding a Safe Harbor Under The Securities Act of 1933*, 34 Fed. Ins. Coun. Q. 421 (Summer 1984).

In contrast to the ruling below, the Tenth Circuit has correctly applied *VALIC I* and *United Benefit* to discretionary payment provisions. In *Olpin* v. *Ideal National Ins. Co.*, 419 F.2d 1250 (10th Cir. 1969), cert. denied, 397 U.S. 1074 (1970), the court held that life insurance policies containing bonus payments, which were set (above a prescribed minimum) in the discretion of the company based on its investment earnings, were not a "security" because the company rather than the policyholders assumed the investment risk (419 F.2d at 1261-1263). The Tenth Circuit's determination that an insurance product containing a discretionary payment provision was not a "security," even though the payment level reflected the company's investment experience, cannot be squared with the Seventh Circuit's decision in this case.

2. *The Court Of Appeals' Decision Rests On A Serious Misapplication Of SEC Rule 151.*

In its opinion on rehearing, the court of appeals made no attempt to reconcile its decision with *VALIC I* and *United Benefit* or even with its own earlier analysis applying the principles of those decisions. Instead, the court's ruling was based entirely on SEC Rule 151 and the failure of VALIC's fixed annuity to satisfy one of the criteria of that "safe harbor" provision. This ruling represents a manifest misapplication of Rule 151.

SEC Rule 151, 17 C.F.R. § 230.151, 51 Fed. Reg. 20,254 (June 4, 1986), is an administrative "safe harbor" that excludes from the federal securities laws any annuity that satisfies its requirements.[10] The Rule is designed "to

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[10] These requirements are that (a) the annuity be issued by a corporation subject to the supervision of the state insurance commissioner, (b) the insurer assume the investment risk under the contract (as defined below), and (c) the annuity not be marketed primarily as an investment. The insurer assumes the investment risk for purposes of the "safe harbor" if (1) the value of the contract does not vary with the investment experience of a separate account, (2) the insurer for the life of the contract guaran-

provide greater certainty" (51 Fed. Reg. at 20,254) in the application of the securities laws by exempting those annuities that are "clearly" (*id.* at 20,255) covered by the insurance provision in Section 3(a)(8) of the 1933 Act.

In promulgating Rule 151, the SEC made unmistakably clear that it is "merely a 'safe harbor,' not an all-inclusive definition purporting to encompass every annuity contract that falls within the section 3(a)(8) exclusion" (51 Fed. Reg. at 20,255). Accordingly, Rule 151 "does not attempt to identify the outer limits of section 3(a)(8)" (*ibid.*). As the Commission emphasized, "[w]hile compliance with rule 151 will assure 'non-security status,' *failure to comply with the rule would not mandate 'security status' for an annuity product*" (emphasis added); rather, "an insurer offering a contract that, for one reason or another, does not satisfy all of the rule's conditions may still rely directly on section 3(a)(8), albeit with no Commission assurance that the contract is covered by the section 3(a)(8) exclusion" (*ibid.*).

Nevertheless, the court of appeals gave *no* reason for holding VALIC's fixed annuity to be a "security" other than the fact that the "excess interest" rate was not guaranteed for one year, as Rule 151 requires for "safe harbor" protection. See App., *infra*, 29a-31a. The court on rehearing did not independently analyze the investment risks under the policy to determine whether the fixed annuity fell within the statutory exemption of Sec-

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tees the principal and a specified rate of interest that meets a prescribed minimum, and (3) the insurer guarantees that any rate of interest in excess of the specified rate will not be modified more frequently than once per year. App., *infra*, 62a-63a. It is this last "excess interest" condition of the "investment risk" requirement that was the basis for the court of appeals' decision on rehearing that VALIC's fixed annuity was a "security" because it did not meet all of the terms of Rule 151.

tion 3(a)(8), as Rule 151 expressly contemplates. Nor did it take issue with the district court's determination (App., *infra*, 42a & n.6) that the SEC had indicated that annuities funded by an insurance company's general asset account were outside the scope of the federal securities laws. Instead, the Seventh Circuit seriously distorted the plain import of Rule 151 by turning the "safe harbor" shield into a statutory sword for limiting the scope of the insurance provision in Section 3(a)(8).[11]

To be sure, when petitioners raised this error below, the court of appeals amended its opinion to disclaim any such use of Rule 151. See App., *infra*, 33a-34a. But that verbal change does not in any way alter the substance of the court's decision. As the Seventh Circuit's opinion unquestionably demonstrates, the *sole* basis for the decision that VALIC's fixed annuity constituted a "security" was the annuity's failure to guarantee an "excess interest" rate for one year—a feature necessary only for purposes of coming within the SEC's "safe harbor." The decision does not even hint at any other ground for categorizing this insurance product as a "security." In so ruling, the court of appeals disregarded this Court's precedents and frustrated the SEC's explicit intent in promulgating Rule 151.

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[11] The court of appeals' erroneous application of Rule 151 is especially glaring in this case. The court did not dispute that VALIC's fixed annuity satisfied all but one of the many requirements for "safe harbor" treatment. The single exception—the one-year "excess interest" component of the investment risk criterion—is only a minor part of the overall regulation, as a fair reading of the Rule and accompanying SEC commentary reveals. Moreover, while VALIC had the right to vary the "excess interest" rate more often than once a year, *in fact it never did so*, and the rate applicable to existing contributions remained unchanged throughout the relevant period. Thus, VALIC's fixed annuity fell short of the requirements of Rule 151 only in the most subsidiary and technical respect.

3. *The Court Of Appeals' Decision Is Inconsistent With The Congressional Scheme Of Exclusive State Regulation Of Insurance.*

The court of appeals' decision also directly interferes with the states' exclusive authority to regulate the business of insurance. Such a result cannot be reconciled with recent rulings of this Court on the proper interpretation of the federal securities laws or with the vital policy of federalism to which Congress has consistently adhered in this area.

In a number of decisions this Court has held that the term "security" must be defined in light of alternative regulatory regimes that Congress intended would apply. In *International Brotherhood of Teamsters* v. *Daniel*, *supra*, for example, the Court, in ruling that a compulsory, noncontributory pension plan is not a "security," reasoned that the "existence of this comprehensive legislation [ERISA] governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to [such plans]" (439 U.S. at 569). Likewise, in *Marine Bank* v. *Weaver*, *supra*, which held that a certificate of deposit issued by a federally regulated bank is not a "security," the Court emphasized the "important fact" that the banking laws provide a "comprehensive set of regulations governing the banking industry" and protect the purchaser against the risk of the issuer's insolvency (455 U.S. at 558).[12] Similar considerations underlie other decisions that have restricted the reach of the federal securities laws in recognition of the regulatory requirements and remedies that exist under state law. See, *e.g.*, *Santa Fe Industries*,

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[12] In its brief as *amicus curiae* in *Marine Bank*, the government, in urging that the certificate of deposit was not a "security," argued (at 11 (emphasis added)) that "the regulation of the banking industry, *like that of the insurance industry*, emphasizes pervasive governmental supervision to substantially eliminate the risk of loss."

Inc. v. *Green*, 430 U.S. at 478-479; *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 40-41 (1977).

Here, too, a holding that VALIC's fixed annuity is a "security" would intrude upon an alternative scheme of regulation under state insurance laws. Indeed, the system of state regulation of insurance at stake in this case is of special significance, because states have long exercised sole authority over the business of insurance. This policy is reflected not only in the insurance exemption in Section 3(a)(8) of the 1933 Act, but also in the McCarran-Ferguson Act, 15 U.S.C. §§ 1011 *et seq.*, which declares that no Act of Congress shall be construed to "invalidate, impair, or supersede any laws enacted by any State for the purpose of regulating the business of insurance." 15 U.S.C. § 1012(b). Thus, courts construing Section 3(a)(8) must "start with a reluctance to disturb the state [insurance] schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements" (*VALIC I*, 359 U.S. at 68).

Without question, application of the federal securities laws to VALIC's fixed annuity would "invalidate, impair, or supersede" state regulation of the business of insurance. See *VALIC I*, 359 U.S. at 67 (application of the federal securities laws "would at least to a degree 'supersede' the state regulations since the Federal Acts prescribe their own peculiar requirements"). In fact, federal securities laws and state insurance regulation follow different approaches: the 1933 and 1934 Acts are based on the philosophy of full disclosure to permit the investor to make informed judgments, while state insurance codes are premised more on the substantive objective of policing the safety and reliability of insurance companies and the policies they issue. See, *e.g.*, *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 460 (1969); *VALIC I*, 359 U.S. at 77 & n.8, 90-91 (Brennan, J., concurring); see also note 12, *supra*.

Insurance companies such as VALIC are subject to comprehensive state regulation, and there are numerous areas of potential overlap or inconsistency between state insurance and federal securities laws. In this case, for example, respondent alleges that the company materially misled her by failing to disclose certain methods for calculating the applicable "excess interest." But the marketing and advertising of insurance policies, including the prohibition of false and deceptive practices, are an integral part of insurance regulation under the McCarran-Ferguson Act, and state insurance departments frequently review and approve annuity policies and supporting materials before they are disseminated to the public.[13] Furthermore, states presumably could go beyond the federal securities laws by affirmatively requiring the disclosure of this information in all cases (without regard to whether its omission was misleading in light of the statements that were made) or, alternatively, by prohibiting altogether the "excess interest" method that VALIC employed.[14]

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[13] See *National Securities*, 393 U.S. at 460; *FTC* v. *National Casualty Co.*, 357 U.S. 560 (1958); *VALIC I*, 359 U.S. at 77 n.8 (Brennan, J., concurring); Tex. Ins. Code Ann. §§ 21.20, 21.21, 21.21A (Vernon 1981 & 1987 Supp.); Ill. Rev. Stat. ch. 73, §§ 760, 761, 766, 1030, 1031 (1985). Because VALIC is a Texas insurance company, and because the class represented by respondent consists of Illinois participants in VALIC's fixed annuity program, we have used the Texas and Illinois insurance codes to illustrate the provisions of state law.

[14] See *VALIC I*, 359 U.S. at 77 (Brennan, J., concurring) ("[p]rescribed contract clauses are ordained legislatively or administratively"); Tex. Ins. Code Ann. § 3.45 (Vernon 1981 & 1987 Supp.); Ill. Rev. Stat. ch. 73, § 838 (1985). See also *id.* § 857.22:

> Any contract providing benefits payable in variable amounts delivered or issued for delivery in this State must contain a statement of the essential features of the procedures to be followed by the insurance company in determining the dollar amount of the variable benefits.

Likewise, states regulate and license the insurance agents who sell annuities,[15] and this too is a fundamental aspect of the regulation of the business of insurance.[16] However, if an annuity is a "security," a separate and wholly different set of federal rules on "broker/dealers" and NASD securities representatives would apply. These rules would require both the company and its agents to comply with numerous provisions that, *inter alia*, govern training and competence, set stringent net capital requirements, and impose mandatory recordkeeping.[17] Beyond doubt, these dual and overlapping regimes of regulation would impair or supersede the authority that Congress intended to leave to the states.

In addition, if an annuity is found to constitute a "security," the issuing company might not qualify for an exemption as an "insurance company" under the Investment Company Act and would be subject to the provisions of that statute.[18] In that event a multitude of federal requirements would become applicable. Some of these, such as limitations on "margin" purchases and "short" sales,[19] are designed to protect the financial stability of the company and therefore overlap the core purpose of state insurance regulation—to ensure the "[s]olvency and the adequacy of reserves" (*VALIC I*, 359 U.S. at 77 (Brennan, J., concurring)). Other requirements,

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[15] See, *e.g.*, Tex. Ins. Code Ann. §§ 21.01, 21.01-1, 21.02, 21.07-1 (Vernon 1981 & 1987 Supp.); Ill. Rev. Stat. ch. 73, §§ 1065.39-2 *et seq.* (1985).

[16] See *National Securities*, 393 U.S. at 460; *Robertson* v. *California*, 328 U.S. 440 (1946).

[17] See 15 U.S.C. §§ 78c(a)(4)-(5), 78o(a)(1), (a)(7), (c)(3); see also, *e.g.*, *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 570 (1979).

[18] See *VALIC I*, 359 U.S. at 67; *United Benefit*, 387 U.S. at 212; 15 U.S.C. §§ 80a-2(a)(17), 80a-3(a), (c)(3).

[19] See 15 U.S.C. § 80a-12(a).

such as those that govern the types of investments that the company may make,[20] would conflict with state supervision of an insurance company's investment portfolio.[21] And still other Investment Company Act restrictions, such as those prohibiting a company from distributing a "security" of which it is the issuer,[22] would require substantial changes in the manner in which the annuity is sold.

The Seventh Circuit's determination that VALIC's fixed annuity is a "security" and not insurance also could frustrate protections afforded policyholders under state insurance laws. In particular, 40 states—including Texas and Illinois—have established state insurance guaranty funds that ensure the payment of benefits and the continuation of coverage for insurance and annuity holders if the issuing company becomes insolvent.[23] However, these provisions are inapplicable to variable annuities or other contracts to the extent that they place the investment risk on the policyholder. Consequently, if a fixed annuity such as VALIC's is considered to be a "security," the decision below might render holders of "excess interest" annuities ineligible for coverage under state insurance guaranty programs, thus doing positive harm to the "beneficiaries" of the decision.

These and similar problems are especially acute in the area of fixed annuities. In contrast to the variable an-

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[20] See 15 U.S.C. §§ 80a-12(d), 80a-13(a)(2).

[21] See *VALIC I*, 359 U.S. at 77 & n.8 (Brennan, J., concurring); Tex. Ins. Code Ann. §§ 2.10, 3.39 (Vernon 1981 & 1987 Supp.); Ill. Rev. Stat. ch. 73, §§ 736 *et seq.* (1985).

[22] See 15 U.S.C. § 80a-12(b).

[23] See, *e.g.*, Tex. Ins. Code Ann. § 21.28-D (Vernon 1981); Ill. Rev. Stat. ch. 73, §§ 1065.80-1 *et seq.* (1985). In addition to Illinois, the other states within the Seventh Circuit also have insurance guaranty funds. See Ind. Code Ann. §§ 27-8-8-1 *et seq.* (West 1980 & 1987 Supp.); Wis. Stat. Ann. §§ 646.01 *et seq.* (West 1986 Supp.).

nuities at issue in *United Benefit*, which were maintained in a separate account that was segregated from the company's other proceeds (387 U.S. at 205),[24] fixed annuities are funded by the company's general assets, which also serve to fund its general insurance obligations (App., *infra*, 38a). Thus, the general assets behind the fixed annuities *are* the insurance company; federal requirements applicable to those annuities *do* regulate the business of insurance; and federal liabilities imposed against these assets *do* affect the company's reserves for meeting its commitments to its insurance holders—the heart of the state insurance system.

In sum, the exclusive state regulation of the business of insurance extends to "regulating the dealings between insurers and their policyholders," including "[t]heir negotiations * * * and the contract which resulted." *National Securities*, 393 U.S. at 459. VALIC's fixed annuities clearly had a substantial—indeed, a predominant—element of insurance. To superimpose federal securities requirements and liabilities on the state insurance structure applicable to these fixed annuities would interfere with that regulatory scheme and would intrude upon the authority of the states, contrary to the analysis of this Court in *Marine Bank* and *Daniel* and in violation of the declared policy of Congress in Section 3 (a) (8) and the McCarran-Ferguson Act.[25]

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[24] Similarly, in *VALIC I*, the company was engaged entirely in the issuance of variable annuities (see *VALIC I*, 359 U.S. at 74 n.3 (Brennan, J., concurring); *United Benefit*, 387 U.S. at 212), and therefore no traditional insurance operations were affected by the Court's decision.

[25] In these circumtances, the fact that the court of appeals' decision is technically interlocutory does not militate against this Court's review. The decision below conclusively holds that VALIC's fixed annuity was a "security"; it is that holding—not the remand for the determination of liability in this particular case—that presents a question of general public importance and immediate practical significance warranting further review. This Court has

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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repeatedly granted certiorari to decide important issues under the federal securities laws, including the proper interpretation of the term "security," notwithstanding the technically interlocutory posture of the case. See, *e.g.*, *Herman & MacLean* v. *Huddleston*, 459 U.S. 375 (1983); *Marine Bank* v. *Weaver*, *supra*; *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979); *International Brotherhood of Teamsters* v. *Daniel*, *supra*; *Santa Fe Industries, Inc.* v. *Green*, *supra*; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975).

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

Nos. 85-1816, 85-1919 and 85-2410

BEVERLY J. OTTO, individually, and on behalf of all others similarly situated,
Plaintiff-Appellant,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,
Defendants-Appellees.

Argued May 15, 1986

Decided Dec. 8, 1986

As Amended Dec. 10, 1986

Before BAUER, Chief Judge, and CUDAHY and RIPPLE, Circuit Judges.

CUDAHY, Circuit Judge.

The named plaintiff, Beverly J. Otto, brought this class action against Variable Annuity Life Insurance Company ("VALIC"), the Variable Annuity Marketing Company ("VAMCO"), a wholly-owned subsidiary of VALIC, certain other affiliated companies, and individual officers and directors of the corporate defendants. Otto alleged violations of the Securities Exchange Act of 1934 (the "1934 Securities Act"), 15 U.S.C.A. § 78a et seq. (West 1981 & Supp. 1986), the Employee Retirement Income

Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1461 (West 1985 & Supp. 1986), and the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C.A. §§ 1961-1968 (West 1984 & Supp. 1986). Otto also alleged conspiracy, breach of contract and common law fraud. The district court granted the defendants' motion for summary judgment on the Securities Act and ERISA claims, dismissed the RICO and conspiracy claims for failure to state a claim upon which relief could be granted, and dismissed the state law claims of breach of contract and common law fraud for lack of jurisdiction. 611 F.Supp. 83. The court refused to reconsider its order or permit Otto to file an amended complaint. 107 F.R.D. 635. We affirm the judgment of the district court, except that we reverse the judgment with respect to the dismissal of the claims of conspiracy to violate ERISA and the 1934 Securities Act and instead grant the defendants' motion for summary judgment on those claims.

I.

VALIC is in the business of selling, among other things, certain annuities which qualify for tax-exempt status under section 403(b) of the Internal Revenue Code. Typically, VALIC enters into a "group unit purchase contract" with a tax-exempt organization such as a public school or college under which the organization permits VALIC to offer its various annuity plans to the organization's employees. If an employee chooses to participate in one of VALIC's plans, he or she directs the employer to contribute a portion of the employee's salary (up to a statutorily prescribed maximum) to purchase an annuity.

VALIC offers participating employees two types of annuity contracts: the fixed annuity and the variable annuity. Under both plans, the principal and any return accumulate during the life of the contract. At the end of the contract, the employee may withdraw the accumu-

lated monies or use them to purchase an annuity from VALIC.

Under the fixed annuity, VALIC guarantees the principal and an interest rate of 4 percent per year for the first ten years and 3½ percent thereafter. "Excess" interest over the guaranteed rate is paid to fixed-annuity participants at the discretion of VALIC. Funds are held in VALIC's unsegregated general account and are invested primarily in long-term debt-type instruments such as mortgages and bonds.

Under the variable annuity, neither the principal nor the rate of return is guaranteed; both fluctuate with VALIC's investment performance. Funds are placed in what is known as a Separate Account, an account segregated from VALIC's general assets. The Separate Account's funds are invested in a diversified portfolio of common stocks and other equity-type investments.

Otto purchased a fixed annuity from VALIC in 1975. On August 2, 1982, she brought this class action on behalf of herself and all Illinois investors who participated in VALIC's fixed annuity plan between October 17, 1975 and August 2, 1982. Otto claims that VALIC failed to disclose the manner in which interest was calculated under the fixed annuity plan—specifically, that it used the "banding" or "new money" method for crediting "excess" interest to the fixed annuity account. Under the banding method, the current rate of excess interest is paid only on deposits made during the current period. All prior contributions continue to earn the rates of excess interest declared during the periods in which those contributions were made. Otto also claims that the defendants failed to disclose the method by which a participant in the fixed annuity plan could maximize his or her rate of return. According to Otto, an employee could earn the current rate of interest by transferring funds from the fixed account into a variable ac-

count for 120 days and then transferring them back into the fixed account. In Counts I, II and III of her amended complaint, Otto contends that the defendants' nondisclosure constitutes a violation of the 1934 Securities Act, a breach of their fiduciary duty under ERISA, and a violation of section 1962(c) of RICO. She alleges in Count IV that the defendants conspired to violate the 1934 Securities Act, ERISA and RICO. Counts V and VI allege breach of contract and common law fraud.

The defendants filed a motion to strike and dismiss Otto's amended complaint and for summary judgment. The district court granted summary judgment on the 1934 Securities Act and ERISA counts, finding these laws to be inapplicable because VALIC's fixed annuity did not constitute a security within the meaning of the federal securities laws or an employee benefit plan within the meaning of ERISA. The court dismissed the RICO count on the grounds that the complaint failed to specify an enterprise and each defendant's role in the alleged pattern of racketeering activity proscribed by that statute. The conspiracy count was dismissed for failure to allege any facts in support of such a claim. With the dismissal of these federal claims which had furnished the basis of pendent jurisdiction, the court dismissed the contract and common law fraud claims.[1]

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[1] Otto asserted in her brief and at oral argument that the district court improperly dismissed the state law claims with prejudice, thereby barring her from pursuing the claims in state court. We believe that Otto has misread the district court's opinion. The district court dismissed the state law claims on the ground that its disposition of the federal claims eliminated any basis for pendent jurisdiction. The court's citation of *United Mineworkers v. Gibbs*, 383 U.S. 715, 725-26, 86 S.Ct. 1130, 1138-39, 16 L.Ed.2d 218 (1966), for support makes clear that the dismissal was without prejudice. Otto is free to pursue her claims of breach of contract and common law fraud in state court.

II.

Section 3(a)(8) of the Securities Act of 1933 exempts from its provisions "[a]ny insurance or endowment policy or annuity contract or optional annuity contract" issued by a corporation subject to supervision by the appropriate insurance regulatory authority. 15 U.S.C. § 77c(a)(8) (1982). The issue before us is whether the fixed annuity plan sold by VALIC is an "annuity" under section 3(a)(8) or whether the plan is an "investment contract" subject to the requirements of the 1934 Securities Act. The district court held that VALIC's fixed annuity was more properly viewed as an insurance product than as an investment contract. Because we agree with the district court's determination that the annuity in question falls within the section 3(a)(8) exemption, we hold that the district court properly granted summary judgment on the 1934 Securities Act claim.

In *S.E.C. v. Variable Annuity Life Insurance Co.* (*"VALIC"*), 359 U.S. 65, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959), the Supreme Court considered whether a variable annuity was a security or insurance. The Court discussed the characteristics distinguishing the variable annuity from the traditional fixed annuity. Generally, the funds underlying the fixed annuity are invested according to conservative standards, and the fixed annuity pays a specified and definite amount to the annuitant. In contrast, the variable annuity's funds are invested primarily in common stocks and other equities, and the variable annuity's benefits vary with the success of the company's investment experience. The holder of a variable annuity, therefore, is not able to depend upon the annuity's paying a fixed return. *Id.* at 69-70, 79 S.Ct. at 620-21. The insurance company in *VALIC* stressed the fact that, as with all insurance, the company assumed the mortality risks under both the variable and the fixed annuity plans. Yet the Court found this characteristic alone an insufficient basis for considering a

variable annuity to be insurance. Insurance, according to the Court, "involves some investment risk-taking on the part of the company" and "a guarantee that at least some fraction of the benefits will be payable in fixed amounts." *Id.* at 71, 79 S.Ct. at 622. An annuity contract that did not guarantee a fixed return thus places all of the investment risk on the policyholder and none on the company. Because there was "no true underwriting of risks," *id.* at 73, 79 S.Ct. at 623, the *VALIC* Court concluded that the variable annuity was a security.

In *S.E.C. v. United Benefit Life Insurance Co.*, 387 U.S. 202, 87 S.Ct. 1557, 18 L.Ed.2d 673 (1967), the Court again explored the distinction between a security and insurance in considering a deferred, or optional, annuity plan. Under this "Flexible Fund" annuity program, the purchaser's premiums less a deduction for expenses (the net premium), and any money earned from investing the premiums, were held in a Flexible Fund Account, which United maintained separately from its other funds. The purchaser was entitled to withdraw the "cash value" of the policy before maturity. The "cash value" was equal to the higher of two amounts: the purchaser's proportional share of the fund or the "net premium guarantee," which was measured by a gradually increasing percentage of the purchaser's net premiums, from fifty percent of net premiums in the first year to one hundred percent after ten years. At maturity, the purchaser had the option of either receiving the cash value of the policy or converting that interest into a life annuity. Although the dollar amount of the fixed payments under the life annuity varied with the cash value of the policy, the net premium guarantee ensured that a minimum annuity would be available at maturity. *Id.* at 205-06, 87 S.Ct. at 1558-59.

The Court assessed the Flexible Fund portion of the contract independently from the annunity portion of the contract and concluded that the Flexible Fund contract

did not fall within the insurance exemption of the federal securities laws. The test to determine whether an instrument is an investment contract, according to the Court, "is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 211, 87 S.Ct. at 1562 (quoting *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53, 64 S.Ct. 120, 124, 88 L.Ed.2d 88 (1943)). The Court noted that the Flexible Fund completely reversed the role of the insurer during the accumulation period. Instead of offering the inducements typical for insurance, such as "stability" and "security," United proposed to serve as an investment agency and promised the policyholder "growth." *Id.* at 211, 87 S.Ct. at 1562. At maturity, the insurer was obligated to produce only the guaranteed minimum, an amount "substantially less than that guaranteed by the same premiums in a conventional deferred annuity contract." *Id.* at 208, 87 S.Ct. at 1560. Although the minimum guarantee "substantially" reduced the investment risk of the purchaser, the Court pointed out that there was a "basic difference between a contract which to some degree is insured and a contract of insurance." *Id.* at 211, 87 S.Ct. at 1562. The Court found the minimum guaranteed in *United Benefit* to be so low that the risk to the insurance company was insignificant.

This court considered whether a "group deposit administration annuity contract" constituted a security or insurance in *Peoria Union Stock Yards Co. v. Penn Mutual Life Insurance Co.*, 698 F.2d 320 (7th Cir. 1983). Under the contract at issue in *Peoria Union*, the employer contributed annually to a deposit account at Penn Mutual to fund a defined-benefit retirement plan for its employees. When an employee retired, the employer could purchase the annuity from the insurance company with a portion of the funds on deposit or it could withdraw funds and purchase the annuity for its employee from

another insurance company. *Id.* at 321. The income available to fund the employer's obligations to its employees for the fixed benefit annuity fluctuated with the investment experience of Penn Mutual. Penn Mutual guaranteed interest on the employer's contributions made during the first three years of the contract at a rate declining from 7½ percent the first year to 3½ percent the third year. Although there was no guarantee of interest after the first three years, any interest earned by the deposit account beyond the interest guarantee was required to be credited to the deposit account. *Id.* at 322. It is unclear from the opinion whether or not the funds for these contracts were held by Penn Mutual in a separate account segregated from its general assets.

This court observed that the contract in *Peoria Union* was similar to the deferred annuity contract in *United Benefit* in that the insurance company actually served as an investment agency and permitted the pension plan to share in the company's investment experience. *Id.* at 325. Moreover, in both cases, the insurance company guaranteed a minimum return so low as to place the investment risk on the investor rather than on the insurance company. *Id.* Based on these characteristics of the plan, the court concluded that during the accumulation phase the annuity plan was an investment contract.

Unlike the plans evaluated in *Peoria Union*, *United Benefit*, and *VALIC*, the defendant VALIC's fixed annuity plan in the present case appealed to potential participants on the usual insurance bases of stability and security. VALIC promoted the fixed annuity as a long-term accumulation of funds for retirement through compound interest. Contributions were mingled with the company's general assets and invested primarily in debt-type securities. Regardless of the investment success of VALIC's general account, VALIC was required to pay a guaranteed rate of interest on all fixed annuity contributions of 4 percent during the first ten years and 3½

percent thereafter. Although this was a low rate of return, it was not so low that we can say it placed the investment risk on the policyholder in a way substantial enough to make the fixed annuity a security. VALIC advertised that, although the earning power of the participant in the fixed plan might not be as great as anticipated due to inflation, the participant had the peace of mind that the investment was guaranteed regardless of economic conditions. Although VALIC boasted that the company's funds were managed by experienced and trained investment managers, as we stated in *Peoria Union*, investment management is the "life blood" of life insurance companies, *Peoria Union*, 698 F.2d at 322, and thus it was not inappropriate for VALIC to tout its investment experience even in relation to an insurance product. The difference between the plan before us and the one considered in *Peoria Union* is not enormous, but the balance of the investment risk has been sufficiently shifted to the insurance company to justify a different result here.

In addition, that VALIC promoted its fixed annuity as insurance is especially apparent when contrasted with its promotion of its variable annuity. VALIC advertised its variable annuity as having a principal objective of long-term capital growth of tax-deferred investments. The contributions of all participants in the variable annuity were held together in a Separate Account, segregated from VALIC's other investments. This Separate Account was invested in common stocks and other equity-type investments. The value of the variable annuity varied with the investment results of the stocks held in the portfolio. VALIC emphasized in its literature that a significant difference between the fixed and the variable annuity was that VALIC assumed the investment risk for the fixed annuity to the extent of guaranteeing minimum fixed rates of compound interest and providing for excess interest credits. The fixed annuity, however, was not intended as a hedge against inflation or the depreciation of the dollar.

Such protection was purportedly afforded by the variable annuity plan for participants willing to accept investment risks.

Our view that VALIC's fixed annuity does not constitute a security is supported by the Securities and Exchange Commission's recent issuance of Rule 151, which establishes a "safe harbor" for certain types of annuity contracts by guaranteeing them exemption from the federal securities laws. 51 Fed.Reg. 20,262 (1986). If a contract complies with the requirements of Rule 151, it is deemed to be an "annuity contract or optional annuity contract" under section 3(a)(8) of the 1933 Securities Act and thus exempt from the provisions of the federal securities laws.[2] Although Rule 151 is not applicable in this case because its effective date is subsequent to the sale in question, an examination of the Rule is nevertheless helpful in determining the scope of the section 3(a)(8) exclusion.

Rule 151 provides:

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[2] In the Securities and Exchange Commission's discussion accompanying the enactment of Rule 151, the SEC emphasized that the Rule does not attempt to cover all annuity contracts that are exempt from the provisions of the Securities Act:

> Rule 151 is merely a "safe harbor," not an all-inclusive definition purporting to encompass every annuity contract that falls within the section 3(a)(8) exclusion. . . . [T]he rule simply defines a class of annuities that the Commission believes is clearly entitled to rely on the section. While compliance with rule 151 will assure "non-security status," failure to comply with the rule would not mandate "security status" for an annuity product. . . . [A]n insurer offering a contract that . . . does not satisfy all of the rule's conditions may still rely directly on section 3(a)(8), albeit with no Commission assurance that the contract is covered by the section 3(a)(8) exclusion.

Definition of Annuity Contract, Discussion Accompanying Enactment of Rule 151, Securities Act Release No. 6645, Fed.Sec.L.Rep. (CCH) ¶ 84,004, at 88,129 (May 29, 1986).

(a) Any annuity contract or optional annuity contract (a "contract") shall be deemed to be within the provisions of section 3(a)(8) of the Securities Act of 1933 [15 U.S.C. 77c(a)(8)], *Provided*, That

(1) The annuity or optional annuity contract is issued by a corporation (the "insurer") subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

(2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this section; and

(3) The contract is not marketed primarily as an investment.

(b) The insurer shall be deemed to assume the investment risk under the contract if:

(1) The value of the contract does not vary according to the investment experience of a separate account;

(2) The insurer for the life of the contract

(i) Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and

(ii) Credits a specified rate of interest (as defined in paragraph (c) of this section) to net purchase payments and interest credited thereto; and

(3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b)(2)(ii) of this section will not be modified more frequently than once per year.

> (c) The term "specified rate of interest," as used in paragraph (b) (2) (ii) of this section, means a rate of interest under the contract that is at least equal to the minimum rate required to be credited by the relevant nonforfeiture law in the jurisdiction in which the contract is issued. If that jurisdiction does not have any applicable nonforfeiture law at the time the contract is issued (or if the minimum rate applicable to an existing contract is no longer mandated in that jurisdiction), the specified rate under the contract must at least be equal to the minimum rate then required for individual annuity contracts by the NAIC Standard Nonforfeiture Law.

51 Fed.Reg. 20,262 (1986).

VALIC's fixed annuity satisfies all of the requirements of Rule 151. VALIC, the insurer, is subject to the insurance laws of Texas and to regulation by the Texas Commissioner of Insurance, as well as to the insurance laws and regulations of all states in which it is licensed to do business, thereby satisfying the first prong, subsection (a) (1), of Rule 151. VALIC's fixed annuity also fulfills the requirement under the second prong, subsection (a) (2), that the insurer assume the investment risk. Contributions are not invested in a separate account and therefore the value of the contract is not tied to the investment experience of such an account. *See* Rule 151 (b) (1). VALIC guarantees that a participant will receive the cash value of all premiums and a specified rate of interest of 4 percent for the first ten years and 3½ percent thereafter. These specified rates of interest are more than the 3 percent minimum rate required under the Rule.[3] *See* Rule 151 (b) (2) (ii). Under subsection

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[3] Illinois has not established a minimum rate of interest for individual annuities under its non-forfeiture statute. Accordingly, we rely on the minimum rate required to be paid for individual annuity contracts under the National Association of Insurance Companies Standard Nonforfeitire Law.

(b) (3), the insurer must guarantee that its rate of excess interest will not be modified more than once per year. Although VALIC does not guarantee that it will leave the excess interest rate unchanged for a year, it does use the "banding" method of computing interest. Under this method, VALIC in effect guarantees the excess interest rate on every deposit for the life of the annuity contract. In its discussion of Rule 151 that was released with the rule's enactment, the SEC made clear that it considered the banding method, or in the SEC's words, the "payment basis" of computing interest, as satisfying this second requirement of Rule 151.[4] Finally, the Rule requires under its third prong, subsection (a) (3), that the contract not be marketed primarily as an investment. Although the award of discretionary excess interest and VALIC's investment experience were given some emphasis, the fixed annuity, as discussed above, was marketed *primarily* on the basis of its stability and security.

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[4] The Commission noted that when it offered the proposed Rule 151 for public comment, several commentators asked how the one-year requirement would be applied to annuities that computed excess interest according to alternative methods such as the banding method used here. The Commission responded as follows:

> In this regard, one commentator observed that excess rates may be established on a contract basis, pursuant to which rates are declared for all funds under the contract, or they may be determined on a payment basis, where specified rates are established for all payments received in a particular time period (day, month, quarter, etc.).
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> * * * *
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> . . . [The Commission does not] wish to prevent insurers from establishing rates on a contract basis or a per payment basis, as described above.

Definition of Annuity Contract, Discussion Accompanying Enactment of Rule 151, Securities Act Release No. 6645, Fed.Sec.L.Rep. (CCH) ¶ 84,004, at 88,134-35 (May 29, 1986).

III.

Otto argues that the district court erroneously granted summary judgment for the defendants on her ERISA count. The district court found that the annuity plan was not maintained or established by Otto's employer and thus was not subject to the provisions of ERISA. Under ERISA, "the terms 'employee pension benefit plan' and 'pension plan' mean any plan, fund, or program which was heretofore or is hereafter *established or maintained by an employer* or by an employee organization, or by both. . . ." 29 U.S.C. § 1002(2)(A) (1982) (Emphasis added). Otto's employer's sole involvement with the annuity plan was to permit VALIC, along with various other companies, to present benefit plans to its employees and, if a VALIC plan was chosen by the employee, to collect the contributions for the plan from the employee and remit them to VALIC. Otto herself emphasized in the district court that the plans sold by VALIC were not established or maintained by a school district or any other governmental agency; rather, the VALIC contracts were "established and maintained only by VALIC." Record, Document 142 (hereinafter R. 142) at 4.[5] Otto nevertheless maintained that the VALIC plan was covered by ERISA because the employer "entered into what

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[5] As Otto admitted in her reply to the defendants' motion to dismiss and for summary judgment:

> It must be emphasized that after the enabling agreement is signed and an employee signs up, nothing but the ministerial duty of withholding the amount designated by the employee and sending it to the company remains for the school district to perform. The school district cannot manage funds, make investment decisions, determine claims, determine benefits, determine costs, change terms, or do anything about the contract. All it can do is withhold money pursuant to the employee's authorization and send it to the annuity company. Thus, these investment annuity contracts are not contracts *maintained* by the school district. R. 131, at 32 (emphasis in original).

may be called an enabling contract with VALIC whereby VALIC may provide investment annuities to the employers." R. 131, at 31-32.

The Department of Labor has promulgated a regulation defining the phrase "established and maintained by an employer" as that phrase is used in ERISA. Under 29 C.F.R. § 2510.3-2(f) (1985), a program for the purchase of an annuity or the establishment of a custodial account shall not be deemed to be established or maintained by an employer within the meaning of ERISA when (among other factors not relevant here) the sole involvement of the employer is to permit annuity contractors to offer their products to employees and collect and remit payment and maintain records of such payments. The construction by the Department of Labor, which is entrusted with the enforcement of ERISA, is entitled to considerable weight. *Abella v. W.A. Foote Memorial Hospital*, 740 F.2d 4, 5 (6th Cir. 1984). *See also Skidmore v. Swift & Co.*, 323 U.S. 134, 140, 65 S.Ct. 161, 164, 89 L.Ed. 124 (1944). We therefore agree with the district court's finding that in the named plaintiff's case the "minimal, ministerial activities [performed by plaintiff's employer] do not render VALIC's fixed annuity plan one 'established or maintained' by the school district." 611 F.Supp. 83, 88 (N.D.Ill. 1985).

Otto argues that the Secretary of the Department of Labor exceeded his authority in enacting this regulation. Under 29 U.S.C. § 1135 (1982), the Secretary may "prescribe such regulations as he finds necessary or appropriate to carry out the provisions of [ERISA]." Thus, the Secretary did not exceed his authority in promulgating Section 2510.3-2(f) defining the phrase "established or maintained by an employer" as used in ERISA.[6]

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[6] Otto also relies on 26 U.S.C. § 403(b), which provides tax-exempt status to an "annuity contract [that was] . . . purchased by an employer." She contends that it is inconsistent for the

Otto argues on appeal, however, that the district court erroneously based its decision to grant summary judgment on the ERISA claim against the entire plaintiff class solely on the facts that applied to the named plaintiff and ignored whatever facts existed concerning the other class members. On appeal, Otto suggests for the first time that the description of the plan set forth by her and relied on by the district court in granting summary judgment "may be unique to Otto." Appellant's Brief at 30. Yet Otto has never before argued that the administration of VALIC's fixed annuity plan differs among employers in any way that would render the plan "established or maintained by an employer." Throughout her pleadings in the court below, and even in her brief submitted to this court, she has described the role played by the employer pursuant to the plan as being the same across employers.[7] Otto may not offer on appeal

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annuity to be deemed to be purchased by an employer for purposes of section 403(b) but not deemed to be maintained or established by an employer for purposes of ERISA. This argument is meritless.

[7] In her brief, Otto emphasizes that "the mechanics of these programs are important for purposes of this litigation." Appellant's Brief at 4. She describes the plan as follows:

> In the usual situation—and this is true in the case of the named plaintiff Otto—an employer is contacted by a number of companies to make available their respective plans to the employer's employees. . . .
>
> The master contract merely empowers the employer to collect the contribution from the employee and pay it over to the company. . . . The employer has no rights of any kind as to investments, pay-outs, records or anything else relating to the investment contract. All matters rest with VALIC and VAMCO the companies selling the contract. The employer abdicates all responsibility of any kind for the plan, except for the sole act of collecting funds and turning them over to the company. . . .

Id. at 4.

arguments against summary judgment that were not raised before the trial court.[8]

IV.

Otto claims that the district court erred in dismissing the RICO count. To allege a violation under section 1962 (c) of RICO, a plaintiff must allege that the defendant "(1) was employed by or associated with (2) an enterprise engaged in, or the activities of which affected, interstate or foreign commerce, and (3) that the person conducted or participated in the conduct of the enterprise's affairs (4) through a pattern of racketeering activity." *Haroco, Inc. v. American National Bank & Trust Co.*, 747 F.2d 384, 387 (7th Cir. 1984), *aff'd*, 473 U.S. 606, 105 S.Ct. 3291, 87 L.Ed.2d 437 (1985). The district court dismissed the RICO count because it failed to identify the enterprise and each defendant's role in the pattern of racketeering activity.

We affirm the dismissal of the RICO count for failure to identify the enterprise. Otto concedes that she did not

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[8] As this court has stated, "[i]t is a well-settled rule that a party opposing a summary judgment motion must inform the trial judge of the reasons, legal or factual, why summary judgment should not be entered. If it does not do so, and loses the motion, it cannot raise such reasons on appeal." *Liberles v. County of Cook*, 709 F.2d 1122, 1126 (7th Cir. 1983).

Further, even if Otto was permitted to raise this argument, her vague suggestion that the facts she has repeatedly recited "may be unique to Otto," Appellant's Brief at 30, may be insufficient to rebut the defendants' strong showing that there exists no genuine dispute as to any material fact relating to the ERISA claim. A plaintiff is required to respond to a defendant's motion with "specific facts showing that there is a genuine issue for trial." Fed.R.Civ.P. 56(e). "Thus, the mere possibility that a factual dispute *may* exist, without more, is not sufficient to overcome a convincing presentation by a moving party." *Quinn v. Syracuse Model Neighborhood Corp.*, 613 F.2d 438, 445 (2d Cir. 1980) (emphasis in original); *see also Celotex Corp. v. Catrett*, —— U.S. ——, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986).

identify the enterprise but argues that she was not required to do so because it was "obvious" that VAMCO was the enterprise.[9] Yet in responding in the district court to the defendants' motion to dismiss for failure to identify the enterprise, Otto suggested that the enterprise here could be "a structural business entity such as VALIC itself, VAMCO, or a board of directors such as the individual defendants, [or] . . . associations in fact, though not a legal entity." R. 131, at 37. Otto's own words reveal that the enterprise was far from "obvious" in her amended complaint.

We therefore do not have to reach the district court's finding that Otto failed to plead with the specificity required by Federal Rule of Civil Procedure 9(b) each defendant's involvement in the fraudulent activity. We note, however, that our finding in *Haroco* that the civil RICO claim made there met the specificity requirements of Rule 9(b) also apparently describes Otto's RICO claim in the present case:

> [T]he complaint adequately specified the transactions, the content of the allegedly false representations, and the identities of those involved. In addition, the identification of the transactions and the description of the alleged scheme to defraud put defendants on fair notice of the time and place of the alleged false representations.

747 F.2d at 405.

V.

Otto claims that all of the defendants conspired to violate RICO, ERISA and the 1934 Securities Act. The district court dismissed the conspiracy count for failure

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[9] "Even though no specific 'enterprise' was named in the Amended Complaint, the status of VAMCO, which made the fraudulent mailing as an agent for its parent VALIC, is obvious." Appellant's Brief at 37.

to state a claim but did not rule on the defendants' motion for summary judgment on the conspiracy claim. We affirm the dismissal of the claim alleging conspiracy to violate RICO. We reverse, however, the dismissal of the claims of conspiracy to violate ERISA and the 1934 Securities Act and find that the district court instead should have granted the defendants' motion for summary judgment on those claims.

To state a claim for conspiracy, a plaintiff must allege the agreement of each defendant to the operation of the conspiracy. *See United States v. Neapolitan*, 791 F.2d 489, 496 (7th Cir. 1986); *Thornton v. Evans*, 692 F.2d 1064 (7th Cir. 1982). A complaint may be dismissed if it contains only conclusory, vague and general allegations of conspiracy. *Fullman v. Graddick*, 739 F.2d 553, 557 (11th Cir. 1984). In dismissing the conspiracy count, the district court stated that "[t]here are simply no facts alleged which permit a reasonable inference that the dozens of defendants, many of whom were no longer affiliated with VALIC when other defendants *began* their association with the company, ever assented to a conspiracy to violate various federal laws." 611 F.Supp. at 90 (N.D.Ill. 1985) (emphasis in original). We disagree with this characterization of Otto's complaint. In her complaint, Otto alleged that each of the defendants agreed and conspired to violate RICO, ERISA and the 1934 Securities Act; she identified each defendant's specific position with the corporation at the time of the alleged conspiracy; and she alleged several overt acts committed by the defendants in furtherance of the conspiracy. We believe that Otto has stated a claim for conspiracy to violate ERISA and the 1934 Securities Act.

However, Otto's claim for conspiracy to violate RICO fails for the same reason her RICO claim failed, that is, she did not identify a RICO enterprise. This circuit has stated that it is the existence of an enterprise that distinguishes a RICO conspiracy from other conspiracies.

Neapolitan, 791 F.2d at 499-50.[10] A RICO conspiracy claim cannot stand absent an allegation of the involvement of an enteprise. We therefore affirm the dismissal of Otto's claim of conspiracy to violate RICO.

After dismissing the defendants' conspiracy count, the district court did not reach their motion for summary judgment on this count. In light of our affirmance of the district court's grant of summary judgment on the 1934 Securities Act and ERISA claims, the defendants clearly were also entitled to summary judgment on the claim of conspiracy to violate those statutes. Otto bases her conspiracy claim almost entirely on her allegations of violations of the underlying statutes. Because we have held those statutes inapplicable to VALIC's fixed annuity plan, there exists no genuine dispute as to whether the defendants conspired to violate them through the promotion of the plan.

A remaining question is whether this court should itself grant the defendants' motion for summary judgment or remand this issue to the district court. The parties have had a full and fair opportunity to argue all relevant aspects of the summary judgment issue, both pursuant to the defendant's summary judgment motion in the district court and in connection with the 1934 Securities Act and ERISA claims before this court. The correct resolution of this issue is clear. Because there is nothing to be gained from a remand, and in the interest of judicial economy, we hold that the defendants are en-

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[10] "[A] distinctive aspect of a RICO conspiracy is the need to establish the existence of an enterprise." 791 F.2d at 499. "[C]onsent to the commission of two criminal acts standing alone does not constitute a RICO conspiracy. The defendant must also agree to 'conduct or participate in the affairs of the enterprise.' Both these elements must be present and together they establish a conspiracy the objective of which is a violation of RICO." *Id.* at 499 n. 5.

titled to summary judgment on Otto's claim of conspiracy to violate ERISA and the 1934 Securities Act.[11]

VI.

In response to the defendants' motion for summary judgment, Otto filed a motion pursuant to Federal Rule of Civil Procedure 56(f) asking for a continuance of the hearing on the defendants' motion and for an opportunity to conduct further discovery. The magistrate, in an opinion adopted by the district court, denied this motion. Otto argues that the district court abused its discretion in denying her motion.[12]

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[11] Appellate courts in analogous situations have chosen to decide, rather than remand, issues where the issue was simple, its resolution was clear, and the parties had been afforded a full opportunity to be heard. *See, e.g., Richmond Leasing Co. v. Capital Bank*, 762 F.2d 1303, 1313 (5th Cir. 1985) ("Remand is unnecessary . . . if 'all the facts relied upon to support the judgment are in the record and are undisputed, or if the record as a whole presents no genuine issue as to any material fact.'") (quoting *King v. Commissioner of Internal Revenue*, 458 F.2d 245, 249 (6th Cir. 1972); *Shaw v. F.B.I.*, 749 F.2d 58, 63 (D.C.Cir. 1984)) ("Since there are no disputed facts, it would be futile to remand the issue to the District Court and we proceed to its resolution."); *In re Hronek*, 563 F.2d 296, 298 (6th Cir. 1977) ("Although we recognize that the normal procedure is to remand a case where the lower court has not considered a pertinent issue, considerations such as judicial economy dictate otherwise where the correct resolution of the issue is clear."); *Smith v. Government of Virgin Islands*, 329 F.2d 135, 142 (3d Cir. 1964) ("Since the record made below fairly presents the issue as to whether [defendants] are entitled to summary judgments judicial economy will patently be served by an immediate determination of this issue rather than remanding these cases to the District Court for disposition.").

[12] Otto also argues that the magistrate construed the defendants' motion as one requesting only dismissal under Rule 12(b)(6). The magistrate did not mischaracterize the defendants' motion. At the outset of her opinion, the magistrate acknowledged that the defendants' motion sought either dismissal or summary judgment.

Summary judgment is proper if the pleadings, depositions, answers to interrogatories and admissions on file, together with any affidavits, show that there is no genuine issue of material fact and that the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c). Thus, if, after adequate time for discovery and upon motion, a party fails to make a showing of a genuine issue of material fact, summary judgment is appropriate. *Celotex Corp. v. Catrett*, —— U.S. ——, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986). Rule 56(f) permits a party who has no specific evidence contradicting an opponent's motion for summary judgment to survive the motion by both presenting valid reasons for the lack of proof and showing how postponement of a ruling will enable the non-movant to rebut the movant's showing. *Gieringer v. Silverman*, 731 F.2d 1272, 1280 (7th Cir. 1984); *Korf* v. *Ball State University*, 726 F.2d 1222, 1230 (7th Cir. 1984). A district court's ruling on a Rule 56(f) motion may be reversed only for an abuse of discretion. *See Korf*, 726 F.2d at 1231.

The magistrate denied additional discovery because plaintiff's Rule 56(f) motion failed to demonstrate a need for further discovery. The defendants' motion for summary judgment was based upon admissions of the plaintiff, documents she had attached to her complaint, and the affidavits of two VALIC employees. The affidavits of the VALIC employees vouched for facts which Otto either already knew or about which she could readily determine whether a dispute existed. Otto did not adequately explain why she was unable to respond to defendants' motion. She merely made the general assertion that she needed an opportunity for additional discovery to respond to the allegations. Otto claimed that discovery had been deferred until after the class had been certified. Any deferral of discovery, however, was due to plaintiff's lack of diligence rather than to a court order. Moreover, Otto failed to indicate how production

of the documents she sought would have assisted her in resisting summary judgment. The district court's refusal to grant a continuance for additional discovery was not an abuse of discretion.

VII.

Otto argues that the court erred in denying her post-trial motions requesting leave to file a second amended complaint. On April 19, 1985, Otto filed a motion to reconsider and for leave to file a second amended complaint. On April 26, 1985, the court denied Otto's request because she failed to attach a second amended complaint to her motion or inform the court how she planned to cure the deficiencies of the first amended complaint. Otto filed a second motion to reconsider and for leave to amend on May 10, 1985. Although she submitted a second amended complaint with her second motion to reconsider, the court found that Otto's motion to reconsider was untimely and that amendment would be futile.

Following an entry of judgment on the dismissal of a complaint by a district court, a plaintiff may amend the complaint under Federal Rule of Civil Procedure 15(a) only after the judgment has been set aside or vacated pursuant to a motion under Rule 59(e) or Rule 60(b) and leave of court to amend has been granted. *Twohy v. First National Bank*, 758 F.2d 1185, 1196 (7th Cir. 1985); *Car Carriers, Inc. v. Ford Motor Co.*, 745 F.2d 1101, 1111-12 (7th Cir. 1984), *cert. denied*, 470 U.S. 1054, 105 S.Ct. 1758, 84 L.Ed.2d 821 (1985). Although leave to amend shall be freely given when justice so requires, Fed.R.Civ.P. 15(a), the decision to allow amendment after dismissal lies within the sound discretion of the trial court. A motion to amend should state with particularity the grounds for the motion and should be accompanied by the proposed amendment. 3 J. Moore, Moore's Federal Practice ¶ 15.12, at 15-115 (2d ed. 1984). Failure to tender an amended complaint with a Rule 59(e) motion may indicate a lack of dili-

gence and good faith. *Twohy*, 758 F.2d at 1197; *see also Verhein v. South Bend Lathe, Inc.*, 598 F.2d 1061, 1063 (7th Cir. 1979) (per curiam) (court may properly refuse request to amend where moving party has not shown proposed amendment has substantial merit).

Otto failed to tender a second amended complaint with her first Rule 59(e) motion. She also failed to explain why a second amended complaint was not filed with the motion. She did not indicate how she planned to cure the deficiencies that resulted in the dismissal of the amended complaint. Rather, she merely stated that she would respond to the defendants' first motions attacking the complaint. Under these circumstances, we cannot say that the trial judge abused his discretion in denying Otto's motion to amend.

The district court construed Otto's second motion to reconsider and for leave to amend as another Rule 59(e) motion and denied the motion as untimely. A motion under Rule 59(e) must be brought within ten days after the entry of judgment. Otto filed her second motion to reconsider twenty-nine days after the court's dismissal of the action and fourteen days after its denial of her first motion to reconsider. Thus, to the extent that the motion may be construed as one brought under Rule 59(e), the district court was correct in denying the motion as untimely.

Otto, on appeal, states that the second motion to reconsider was brought under Rule 60(b), which allows relief from judgment for, among other things, mistake, inadvertence, excusable neglect, newly discovered evidence and fraud.[13] She, however, does not point to a specific permissible reason under 60(b) which applies to this

[13] Motions pursuant to Rule 60(b) must be made "within a reasonable time" and in some instances within one year of the judgment. If Otto's motion was properly brought under Rule 60(b), it was not untimely.

case. In her second motion to reconsider, Otto explained why a second amended complaint had not accompanied her first motion to reconsider and how the attached second amended complaint corrected the deficiencies of the first amended complaint. In addition, she argued the merits of the court's order dismissing the action. We agree with the district court that Otto's request was for the court to amend its judgment by correcting errors of law under Rule 59(e) rather than for relief from judgment for any reason allowed under Rule 60(b). Accordingly, the district court's refusal to reopen the judgment was not an abuse of discretion. Because Otto was not successful in reopening the judgment, her motion for leave to amend was a nullity and the decision of the district court denying leave to amend was correct. *See Car Carriers*, 745 F.2d at 1112.

AFFIRMED.

APPENDIX B

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

Nos. 85-1816, 85-1919 and 85-2410

BEVERLY J. OTTO, individually, and on behalf of all others similarly situated,
Plaintiff-Appellant,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,
Defendants-Appellees.

Opinion on Rehearing April 15, 1987

OPINION ON REHEARING

CUDAHY, Circuit Judge.

Following the issuance of our opinion in this case, the defendant, Variable Annuity Life Isurance Company ("VALIC"), filed a motion to modify the opinion, and the plaintiff, Otto, filed a petition for rehearing. In its motion to modify the opinion, VALIC for the first time informed this court that it claimed to have the right to alter, at its unfettered discretion, the interest "bands" paid on past contributions. Earlier, both before the district court and this court, VALIC had claimed only that it had the discretion to declare the excess interest rate to be paid on new deposits. VALIC emphasized that

these discretionary changes in the excess interest rate affected only current deposits and that past deposits would continue to earn the interest rate in effect at the time the deposit was made:

> Like virtually all of its competitors at that time, VALIC employed the "new money" or "banding" method for crediting excess interest to the fixed annuity account; *i.e.*, the excess interest rate set by the Board of Directors was paid on deposits made during that particular period. Subsequent fluctuations in the excess rate did not affect a participant's past contributions. Each deposit stayed in its "band," and continued to draw interest at the rate in effect when the deposit was made.

Defendants' Brief at 4-5 (footnote omitted). VALIC made similar representations in its literature soliciting participants for its fixed annuity plan. A formal written proposal, which VALIC said was sent to "virtually all, if not all, prospective customers" in the Midwest Region during the years 1979 to 1983, contained the following question and answer:

> Describe the basis for the dividends or current interest rate illustrated above. The current rate of interest is composed of the guaranteed interest rate plus "excess interest." Excess interest is declared and guaranteed for deposits received in the Fixed Account on a calendar quarter basis by the Board of Directors of VALIC. Excess interest is computed daily and credited on amounts remaining in a participant's Fixed Account at the end of each calendar quarter.
>
> VALIC employs the new money method for crediting excess interest. The current interest rate is paid on monies for the period in which it is in effect. *Should the current interest rate change (i.e., up or down), it would not affect a participant's past contributions but only those contributions deposited*

> *while the new rate is in effect.* A change in the current rate would in no way affect the past accumulations in a participant's account balance.

Defendants' Memorandum in Opposition to Plaintiff's Motion for Class Certification, Exhibit C (emphasis added). Based on repeated statements such as this made by VALIC coupled with VALIC's failure to assert the right to alter past bands, this court concluded that the interest bands were guaranteed for the life of the contract.

We will accept solely for the purposes of this rehearing VALIC's assertion that it had the right to change at any time the interest bands paid on past deposits. The question then becomes what effect does this new fact have on our determination that the fixed annuity was an insurance product rather than a security and therefore not subject to federal securities laws. Not surprisingly, VALIC argues that the soundness of our prior determination is unaffected. VALIC suggests that we merely delete from our opinion the following sentence: "Under this method, VALIC in effect guarantees the excess interest rate on every deposit for the life of the annuity contract." *Supra*, at 1134. Otto, on the other hand, argues that the correctness of that sentence is crucial to the opinion's determination that the fixed annuity is not a security but an insurance product. Otto requests, both in its response to VALIC's motion and in its petition for rehearing, that we withdraw our entire discussion of this issue and find instead that the fixed annuity is a security. We agree with Otto that we cannot simply delete the sentence and leave the remainder of the discussion untouched. We therefore supplement section II of our prior opinion with this opinion. Upon reexamination in light of VALIC's newly asserted right to alter past interest bands, we hold that VALIC's fixed annuity plan is a security subject to the federal securities laws.

The amount of discretion retained by VALIC to alter the interest it paid under the fixed annuity is relevant to the level of the investment risk assumed by VALIC. As discussed in our previous opinion, the Supreme Court, this circuit and the Securities and Exchange Commission (the "SEC") all have found that the degree of investment risk assumed by the insurance company is an important factor in determining whether a particular annuity plan is an insurance product or a security. The Supreme Court has stated that insurance "involves some investment risk-taking on the part of the company" and "a guarantee that at least some fraction of the benefits will be payable in fixed amounts." *S.E.C. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 71, 79 S.Ct. 618, 622, 3 L.Ed.2d 640 (1959). The Court has also noted that there is "a basic difference between a contract which to some degree is insured and a contract of insurance." *S.E.C. v. United Benefit Life Ins. Co.*, 387 U.S. 202, 211, 87 S.Ct. 1557, 1562, 18 L.Ed.2d 673 (1967); *see also Peoria Union Stock Yards Co. Retirement Plan v. Penn Mutual Life Insurance Co.*, 698 F.2d 320 (7th Cir. 1983). The SEC recently enacted Rule 151 which defines more precisely what constitutes sufficient investment risk-taking by an insurance company to ensure that an annuity will be considered an insurance product and exempt from the federal securities laws pursuant to section 3 (a) (8) of the 1933 Securities Act. VALIC itself relied on the then proposed Rule 151 in its initial brief before this court. VALIC argued that "[a]lthough the Rule, even if adopted, would not apply to the product sold (between 1975 and 1982) to Otto and other class members, the . . . fixed annuity nonetheless largely satisfies the requirements contained in the proposed Rule. . . ." Defendants' Brief at 17.

The second of the three prongs of Rule 151 requires that "[t]he insurer assumes the investment risk under the contract" as further defined in the rule. In order for

the insurer to be "deemed to assume the investment risk" under the rule, the insurer must, among other things, "guarantee[] that the rate of any interest to be credited in excess of [the guaranteed minimum] . . . will not be modified more frequently than once per year." In its brief on rehearing, VALIC concedes that the fixed annuity does not satisfy this requirement given VALIC's claimed right to alter past interest bands. VALIC asserts that it has the absolute right to stop all excess interest payments on all deposits, past or present: "[E]xcess interest is wholly discretionary; with its unfettered discretion, VALIC can calculate excess interest by any method it chooses, it can elect to change the current interest rate paid on deposits, it can change the rates on past contributions, and (although competition makes it unlikely) it can stop paying excess interest altogether—at any time." Defendants' Brief on Rehearing at 8 (footnote omitted). A claimed right to change established excess interest rates and to eliminate excess interest payments entirely *at any time* surely tends to shift the investment risk from VALIC to the plan participant. VALIC, however, argues that its failure to meet this requirement of Rule 151 does not require a change in our prior determination that the fixed annuity qualified for the 3(a)(8) exclusion. VALIC argues that our prior conclusion that VALIC bears a sufficiently substantial risk "is solidly based on the substantiality of the *guaranteed* rates, a fact entirely independent of the availability of discretionary excess interest." *Id.* at 9 (emphasis in original).

The SEC in adopting Rule 151 rejected VALIC's view that guaranteeing a low minimum interest rate is a sufficient assumption of the investment risk by the insurance company. In Securities Act Release No. 6645 in which the SEC offers guidance in interpreting Rule 151, the SEC notes that several commentators suggested that the requirement of a one-year excess interest guarantee

be removed from the rule. The SEC rejected that suggestion and retained the one-year requirement, explaining its reasoning as follows:

> While the commentators make some reasonable arguments, the Commission is adopting the one-year requirement as proposed. Taking the position that various types of excess interest contracts are entitled to rely on the section 3(a)(8) exclusion is itself a major step. The length of time between interest rate modifications is one legitimate measure of the degree of investment risk assumed by the insurer. Designing a "safe harbor" rule is essentially a matter of balancing the legitimate interests of flexibility in structuring insurance products against the need to provide adequate investor protection. Where the limits of the "safe harbor" are set is a matter of discretion and judgment. The Commission believe, therefore, that the one-year period is, on balance, a reasonable condition, complementing the two other components of the rule's investment risk test.

Definition of Annuity Contract, Discussion Accompanying Enactment of Rule 151, Securities Act Release No. 6645, Fed.Sec.L.Rep. (CCH) ¶ 84,004, at 88,134 (May 29, 1986). We find that on the facts of this case the minimum interest rates guaranteed under VALIC's fixed annuity plan, although they are somewhat in excess of those required by Rule 151, alone do not place the investment risk on VALIC sufficiently to exempt the plan from the federal securities laws. To find otherwise we would have to overlook *entirely* any requirement for a guarantee of excess interest. To do this would be to disregard completely one element contained in the investment risk test of the SEC's safe harbor Rule 151. Admittedly this is not an element relied on previously in court decisions distinguishing securities from insurance products. But it is an element the SEC has insisted on over the objection of some commentators. Since Rule 151 was cited to

us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC. We therefore find that VALIC's fixed annuity plan is a security. On rehearing, we reverse the district court's order granting summary judgment for the defendants on the alleged violations of the Securities Exchange Act of 1934 and remand for further proceedings consistent with this opinion.

REVERSED AND REMANDED.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

June 10, 1987

Before

HON. WILLIAM J. BAUER, *Chief Judge*
HON. RICHARD D. CUDAHY, *Circuit Judge*
HON. KENNETH F. RIPPLE, *Circuit Judge*

Nos. 85-1816, 85-1819 and 85-2410

BEVERLY J. OTTO, individually, and on behalf of all others, similarly situated,
Plaintiff-Appellant,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,
Defendants-Appellees.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division

No. 82 C 4762—Marvin E. Aspen, *Judge*

ORDER AMENDING OPINION

The opinion in the above-entitled case, (814 F.2d at 1127), is amended as follows:

Immediately after the sentence "Because Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC," (814 F.2d at 1142), add the following language

We do not say that Rule 151 defines the meaning of "security"; it is a safe harbor rather than a definitional rule, as our first opinion observes, *see supra* at 1133 n.2. But VALIC's argument directly under the statute depends on its assertion that the guaranty of return here requires calling the instrument insurance under § 3(a)(8) even if the prospect of "excess" interest is a principal inducement to purchase this particular instrument. Because the contract actually leaves the investor with an investment risk significant enough to throw its status into doubt, VALIC's argument in this court effectively depended on its own analogy to the standards of Rule 151, which has not sufficed.

APPENDIX D

UNITED STATES DISTRICT COURT
N.D. ILLINOIS, E.D.

No. 82 C 4762

BEVERLY J. OTTO, Individually and on Behalf of all Others Similarly Situated,
Plaintiff,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, a Stock Life Insurance Company Organized Under the Laws of the State of Texas, CHARLES T. BAUER, MORTIMER M. CAPLIN, HENRY CHAUNCEY, HARRY C. COPELAND, JR., W. THOMAS FIQUET, FREDERICK M. GLASS, GRINNEL MORRIS, ROY T. PARKER, JR., ROBERT S. PHILLIPS, MICHAEL E. PUYANS, W. DAWSON STERLING, BENJAMIN N. WOODSON, PHILIP G. DAVIDSON III, ANDREW DELANEY, JOE F. FLACK, RICHARD H. HANNEMAN, HAROLD S. HOOK, MARDEN MILLER, JOHN J. PLUMB, GEORGE F. REED, ROBERT L. BALDWIN, STEPHEN D. BICKEL, TERRENCE J. CONLAN, JOE D. HEUSI, JOHN D. HOGAN, WILLIAM B. PARDUE, WILLIAM C. PHELPS, MICHAEL J. POULOS, ROBERT O. PURCIFULL, DIANE G. D'AGOSTINO, and GREGORY C. WILCOX, Individually Variable Annuity Life Insurance Company Separate Account One, and AMERICAN GENERAL CORPORATION,
Defendants.

April 11, 1985

MEMORANDUM OPINION AND ORDER

ASPEN, District Judge:

Plaintiff Beverly J. Otto ("Otto"), on behalf of herself and others similarly situated, brings this suit against the Variable Annuity Life Insurance Company ("VALIC") and certain affiliated companies and named directors of VALIC, alleging, *inter alia*, violations of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*; the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. § 1001 *et seq.*; and the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968. Otto essentially claims that the defendants have unlawfully failed to disclose to investors in VALIC's fixed annuity program the manner in which interest is calculated on their deposits, as well as the method by which investors can transfer their funds so as to maximize their rate of return. On March 15, 1984, the Court granted Otto's motion for class certification, permitting her to represent the class of all Illinois investors who participated in VALIC's fixed annuity program between October 17, 1975, and August 2, 1982. Presently before the Court is defendants' motion to strike and dismiss and for summary judgment. For the reasons set forth below, defendants' motion is granted.

Count I

Defendants offer several reasons why the complaint's securities fraud count fails to state a claim upon which relief can be granted and why defendants are entitled to summary judgment on that count as a matter of law. We need address only one of these reasons, defendants' assertion that the fixed annuity is not a security.

Defendants argue that VALIC's fixed annuity is not within the scope of the Securities Exchange Act of 1934 because it falls into the statutory exemption for "any

insurance or endowment policy or annuity contract or optional annuity contract" issued by a regulated insurance company. 15 U.S.C. § 77c(a)(8).[1] Otto, on the other hand, argues that VALIC's fixed annuity should be characterized as an "investment contract," one type of security defined in 15 U.S.C. § 78c(a)(10).[2] Although the term "investment contract" is a catch-all to bring within the securities acts various interests that have the functional attributes of stock and other formal securities but are not so denominated, *Peoria Union Stock Yards Company Retirement Plan v. Penn Mutual Life Insurance Co.*, 698 F.2d 320, 324 (7th Cir. 1983), we agree with defendants that the fixed annuity is more properly viewed as an insurance product than as an investment contract.

The contract under which Otto and the other class members became participants is designed for annuity

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[1] Indeed, although the statute refers to insurance policies and annuities as "exempted securities," they are probably more accurately considered not to be securities at all. *See* H.R.Rep. No. 85, 73d Cong., 1st Sess. 15; 3 H. Bloomenthal, Securities and Federal Corporate Law § 2.08[1] (1984 rev.).

[2] The "investment contract" provision is in fact the *only* part of the definition of "security" which arguably applies to this case. Section 78c(a)(10) provides:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

purchase plans adopted by public school systems and certain tax-exempt organizations pursuant to Section 403 (b) of the Internal Revenue Code, 26 U.S.C. § 403(b). Under the contract's terms, participants may designate a portion of their salaries for deposit into either a variable or a fixed annuity account, and those amounts (up to a statutory maximum) are excluded from the participants' gross income for the year.

Since 1968, VALIC's *variable* annuity has been funded through Separate Account One, a diversified open-end management investment company registered under the Investment Company Act of 1940. Funds contributed by participants are segregated from VALIC's other assets and are invested primarily in a diversified portfolio of common stocks and other equity-type investments. The participants bear all the investment risks with this annuity; neither interest nor the principal contributed by the participants is guaranteed by the company. The participants' profits thus depend solely upon the expertise and investment success of those who invest the funds in the Separate Account.

The *fixed* annuity, the subject of this lawsuit, operates quite differently. Participants' contributions become a part of the company's general assets.[3] The stated primary objective of the fixed annuity is to provide insured retirement stability by long-term accumulation of funds through compound interest. VALIC bears the investment risk, because it guarantees the return of both principal and a minimum of 4% compound annual interest for the first ten years of participation and 3½% interest thereafter. Interest above the minimum level may be paid in the discretion of VALIC's board of directors.

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[3] As defendants point out, state insurance regulations strictly limit the types of investments which insurance companies can make. *See, e.g.*, Ill.Rev.Stat. ch. 73, ¶ 736 *et seq.* Therefore, the company's funds typically go into conservative debt-type securities, mortgages and bonds, with fixed rates of return.

Otto asserts that the status of VALIC's fixed annuity as a security is settled "beyond all question" by three cases: *SEC v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959); *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 87 S.Ct. 1557, 18 L.Ed.2d 673 (1967); and *Peoria Union Stock Yards*. These cases do shed some light on this issue, but they do not support, much less compel, the conclusion Otto reaches.

The Supreme Court decided long ago that a *variable* annuity offered by VALIC was a security. *VALIC*, 359 U.S. at 71, 79 S.Ct. at 622.[4] In doing so, the Court distinguished traditional fixed annuities from the more recently evolved variable annuities. *Id.*, 359 U.S. at 69, 79 S.Ct. at 621. Unlike their predecessors, variable annuities were to be treated as securities rather than insurance products, in large part because they placed the entire investment risk on the annuitant. "For in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts." *Id.*, 359 U.S. at 71, 79 S.Ct. at 622.

The Supreme Court discussed the relationship between annuities and the federal securities laws further in *United Benefit*. That case involved a deferred, or optional, annuity plan called a "Flexible Fund Annuity" contract, under which the purchaser agreed to make certain annual contributions until a specified maturity date. The insurance company invested most of the Flexible Fund contributions in common stocks, with the object of producing capital gains as well as an interest return. "Instead of promising to the policyholder an accumulation to a fixed amount of savings at interest, the insurer promise[d] to serve as an investment agency

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[4] We note once again that it is VALIC's fixed, and not variable, annuity which is at issue in this case. Otto occasionally blurs the distinctions between the two, both in the complaint and in her brief opposing defendants' motion.

and allow the policyholder to share in its investment experience." *United Benefit*, 387 U.S. 202, 208, 87 S.Ct. 1557, 1560. Upon maturity the purchaser could either withdraw his contributions, plus the earnings that had accumulated through the insurer's investment of those contributions, or use them to purchase an annuity from the company. Whatever his choice, the purchaser was guaranteed a low minimum value (with no interest component) at maturity.

The Court found that the accumulation portion of this annuity plan was an investment contract rather than an insurance product. Although the cash value guarantee reduced somewhat the investment risk of the purchaser, this was not enough. The Court stated that "'[t]he test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.'" *Id.*, 387 U.S. at 211, 87 S.Ct. at 1562, quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53, 64 S.Ct. 120, 124, 88 L.Ed. 88 (1943). The Flexible Fund was "considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management." *United Benefit*, 387 U.S. at 211, 87 S.Ct. at 1562. Given the plan's pitch to growth through professionally managed investment, the Court deemed it fair to apply the securities laws to it. *Id.*

VALIC's fixed annuity differs significantly from the plans in these two Supreme Court cases. VALIC bears the investment risk, guaranteeing the return of the participants' contributions plus interest. Moreover, the economic inducement of the fixed annuity is indeed the "usual insurance basis of stability and security" rather than growth through investment. The company's literature clearly emphasizes the different objectives of the variable and fixed annuities: the former is "long-term capital growth," which the latter is the more secure

"long-term accumulation of funds for retirement through compound interest." *See, e.g.*, VALIC's *Owner's Manual*, Exhibit B to Otto's complaint. The stability of the fixed annuity was apparent to Otto, who stated that she chose this annuity instead of the variable annuity because she did not like "the fluctuating rates" and wanted "a more conservative investment." Otto deposition, p. 25.[5] Accordingly, VALIC's fixed annuity is distinguishable from the annuities which the Supreme Court has found to be within the reach of the securities laws.

Nor does the Seventh Circuit opinion in *Peoria Union Stock Yards* bolster Otto's claim that the fixed annuity should be treated like a security. That case dealt with a "group deposit administration annuity contract" sold by an insurance company to pension trustees. The insurance company guaranteed interest payments (at a rate declining from 7½% to 3½%) on contributions made during the first three years of the contract, but it made no guarantee on later contributions. *All* the contributions, however, were to be credited with whatever investment income the insurance company could realize, less certain modest administrative charges. Thus, the Seventh Circuit found that the insurance company bore even less of the investment risk than did the company in *United Benefit*, and that any profits of the enterprise were due solely to the investment efforts of the insurance company. *Peoria Union Stock Yards*, 698 F.2d at 325. This plan is thus distinguishable from VALIC's fixed annuity in the same way as the contracts in *VALIC*

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[5] Otto asserts in her response brief that the guaranteed rates of interest were hardly enough to attract anyone to the contract and that the incentive was the discretionary interest payable. This assertion ignores the substantial pecuniary benefits of excluding the contribution amounts from gross income for tax purposes and is belied by Otto's stated aversion of "fluctuating rates" (the discretionary interest, of course, was just that—discretionary—and could be varied or omitted at any time).

and *United Benefit*—"the insurance company is offering the pension plan a chance to share in the insurance company's investment experience." *Id.* VALIC offers this chance to its customers through the variable, not the fixed, annuity.

Our decision that VALIC's fixed annuity is not a security is supported by the SEC's view that "neither the general account nor any interests therein are generally subject to the provisions of the 1933 or 1940 Acts. . . ." [6] Although not controlling, the Commission's interpretation of the securities laws is entitled to considerable weight. *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-19, 95 S.Ct. 2427, 2442, 45 L.Ed.2d 486 (1975).

Accordingly, we hold that Otto's securities fraud claim must fail because VALIC's fixed annuity is not a security.

Count II

Defendants make a two-pronged attack on the complaint's ERISA count. First, they argue that ERISA does not cover VALIC's fixed annuity because the annuity is not "employer maintained"—and ERISA applies only to plans or funds "established or maintained by an employer." 29 U.S.C. §§ 1002(2)(A), 1003(a).[7] Second, defendants argue that even if the fixed annuity were considered to be "employer maintained," the annuity would be excluded from ERISA's coverage because Otto's employer is a governmental subdivision. 29 U.S.C.

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[6] *See* letter of January 31, 1984, to VALIC from Thomas E. Neal, Assistant Chief of the SEC's Office of Insurance Products and Legal Compliance, attached to defendants' supporting brief.

[7] Section 1002(2)(A) provides in pertinent part: "[T]he terms 'employee pension benefit plan' and 'pension plan' mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both. . . ."

§§ 1002(32), 1003(b)(1). Defendants' first argument is persuasive.[8]

Both Otto and defendants agree that the school district does no more than: (1) permit annuity contractors to publicize their products to employees, and (2) collect and remit to contractors the contributions designated by participating employees. These minimal, ministerial activities do not render VALIC's fixed annuity plan one "established or maintained" by the school district.[9] VALIC's annuity therefore does not fall within the statutory definition of "employee pension benefit plan" or "employee benefit plan" and therefore is not covered by ERISA. The ERISA claims of Otto and all other members of the plaintiff class must be dismissed.[10]

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[8] Most of Otto's response is devoted to defendants' second argument. In contending that no governmental exemption applies to VALIC's fixed annuity, Otto emphasizes the fact that the annuity plan is not established or maintained by her school district employer, but rather is formulated and completely controlled by VALIC. While this vitiates defendants' second argument, it strengthens their first.

[9] This conclusion is in accord with a Department of Labor regulation, 29 C.F.R. § 2510.3-2(f), which explains that tax sheltered annuities such as VALIC's shall not be deemed to be "established or maintained by an employer" when the employer's involvement is limited (as in this case). Otto's arguments that we should disregard this regulation are unconvincing.

[10] After defendants filed the reply brief for their motion, Otto filed a motion seeking leave to add three additional persons as named plaintiffs in this action. Otto's motion was clearly a response to defendant's governmental exemption argument, as the three putative additional class representatives are employees of a private, non-governmental entity. However, their inclusion in this suit would have no effect—the ERISA claim is dismissed *not* because Otto's employer is a governmental subdivision, but because the annuity plan is not established or maintained by the employer (whether it be governmental or non-governmental). Accordingly, Otto's motion is denied.

Count III

Otto alleges in Count III that each of the thirty-one individual and four corporate defendants have violated the civil RICO statute. She claims that the defendants went astray from 18 U.S.C. § 1962(c), which prohibits a person from conducting the affairs of an enterprise that is engaged in, or whose activities affect, interstate commerce through a "pattern of racketeering activity." Section 1961 defines a pattern of racketeering activity as at least two occurrences within ten years of any of several predicate offenses, including mail fraud, bribery and fraud in the sale of securities.

The Seventh Circuit recently discussed the elements of a section 1962(c) claim in *Haroco, Inc. v. American National Bank and Trust Co. of Chicago*, 747 F.2d 384 (7th Cir. 1984), *cert. granted*, —— U.S. ——, 105 S.Ct. 902, 83 L.Ed.2d 917 (1985):

> To allege a violation of section 1962(c), the plaintiff must allege that the defendant (1) was employed by or associated with (2) an enterprise engaged in, or the activities of which affected, interstate or foreign commerce, and (3) that the person conducted or participated in the conduct of the enterprise's affairs (4) through a pattern of racketeering activity.

Id., 747 F.2d at 387. Defendants claim that Otto's allegations are deficient in various respects, requiring dismissal of the RICO count. We agree with at least two of defendants' arguments.

Defendants first argue that the RICO count is fatally defective because it fails to identify any "enterprise." Indeed, the complaint uses the term "enterprise" twice (in paragraphs 74 and 75), but nowhere explains what enterprise was involved. Otto's response brief does nothing to clear up matters; to the contrary, it simply states at different points that the enterprise *might* be VALIC or VAMCO or a board of directors or an asso-

ciation in fact of the individual defendants and "the corporation." [11]

To establish an enterprise, Otto must plead and prove that "the various associates function[ed] as a continuing unit" and that the enterprise existed "separate and apart from the pattern of activity in which it engage[d]." *United States v. Turkette*, 452 U.S. 576, 583, 101 S.Ct. 2524, 2528-29, 69 L.Ed.2d 246 (1981). Moreover, the same individual or corporation may not be both the liable "person" and the "enterprise" under section 1962(c). *Haroco*, 747 F.2d at 400. Unless Otto specifies the enterprise involved in this case, it is impossible to determine if she has satisfied these other requirements as to each of the defendants. Accordingly, the RICO claim as stated in Count III is insufficient. *E.g.*, *Bennett v. Berg*, 685 F.2d 1053, 1061-62 (8th Cir. 1982), *aff'd in part and rev'd in part*, 710 F.2d 1361 (8th Cir. 1983) (en banc), *cert. denied*, —— U.S. ——, 104 S.Ct. 527, 78 L.Ed.2d 710 (1983); *see also Laterza v. American Broadcasting Co., Inc.*, 581 F.Supp. 408, 414 (S.D.N.Y. 1984) (general assertion that combination of defendants constituted an "enterprise," without allegation as to continuity of structure or personnel, was insufficient).

Defendants also point out a second, perhaps greater deficiency—Otto's failure to specify each defendant's role in a "pattern of racketeering activity." The complaint refers to three kinds of predicate offenses which might be a part of such a pattern: mail fraud, wire fraud (which Otto incorrectly calls "false pretenses"), and violations of the federal securities laws. As explained above, Otto has failed to state a claim for any securities laws violation. Thus, to establish a pattern of racketeering activity, Otto must allege at least two instances of mail or wire fraud.

There is little doubt that Fed.R.Civ.P. 9(b), which requires that allegations of fraud specify "with particular-

[11] It is not at all clear which corporation Otto means.

ity" the circumstances of the alleged fraud, applies to fraud allegations in civil RICO complaints. *Haroco*, 747 F.2d at 405. Defendants contend that Otto has not satisfied Rule 9(b) because she fails to identify any allegedly false documents and fails to specify how any of the defendants were involved in sending any documents. We disagree with defendants' first contention, as the complaint refers to (and attaches as exhibits) three specific "investment prospectuses, financial and interest statements." Complaint, paragraph 73(a). However, we do agree with defendants' second contention, that the complaint fails to sufficiently plead each defendant's respective involvement in any fraudulent activity. In fact, the complaint is devoid of *any* factual allegations concerning particular defendants. The complaint's conclusory allegations, which merely attribute fraudulent representations to thirty-five defendants collectively, are not specific enough to satisfy Rule 9(b). *Hudson v. La Rouche*, 579 F.Supp. 623, 628-29 (S.D.N.Y. 1983); *D & G Enterprises v. Continental Illinois National Bank and Trust Company of Chicago*, 574 F.Supp. 263, 267 (N.D. Ill. 1983). The inadequacy of the fraud allegations is especially great regarding the individual defendants, many of whom left VALIC before 1978 or joined VALIC after the purportedly fraudulent documents were issued. Accordingly, the complaint's RICO count is dismissed.

Count IV

In Count IV, Otto alleges that all the defendants conspired to violate the Securities Exchange Act of 1934, ERISA and RICO, the same statutes on which she relies in Counts I, II and III. At a minimum, a conspiracy requires allegations and proof of one overt act by a defendant in furtherance of the conspiracy, and the assent of each defendant to the operation of the conspiracy. *United States v. Sutherland*, 656 F.2d 1181, 1186-87 n. 4 and 1193 (5th Cir. 1981), *cert. denied*, 455 U.S. 949, 102 S.Ct. 1451, 71 L.Ed.2d 663 (1982). The defendants ar-

gue that Otto's allegations fail to meet even this minimum requirement. We agree.

It may be theoretically possible for defendants to have conspired to violate RICO or even the federal securities laws or ERISA (which, as explained above, defendants actually could not have violated).[12] However, general allegations of a conspiracy which are unsupported by facts are not enough to state a cause of action. *Saine v. A.I.A., Inc.*, 582 F.Supp. 1299, 1307 (D.Colo. 1984). The allegations in Count IV are even sketchier than those in Count III, which we have found inadequate to state a RICO claim against any particular defendant. There are simply no facts alleged which permit a reasonable inference that the dozens of defendants, many of whom were no longer affiliated with VALIC when other defendants *began* their association with the company, ever assented to a conspiracy to violate various federal laws. Thus, Count IV fails to state a cause of action and must be dismissed.

Counts V and VI

In Counts V and VI, Otto asserts two state law claims: breach of contract and common law fraud. Because the federal claims in Counts I through IV are all dismissed, there is no longer any basis for this Court to exercise pendent jurisdiction over the state law claims. *United Mineworkers of America v. Gibbs*, 383 U.S. 715, 725-26, 86 S.Ct. 1130, 1138, 16 L.Ed.2d 218 (1966); *Americana Healthcare Corp. v. Schweiker*, 688 F.2d 1072, 1087 (7th Cir. 1982), *cert. denied*, 459 U.S. 1202, 103 S.Ct. 1187, 75 L.Ed.2d 434 (1983). Therefore, these counts are dismissed as well.

Accordingly, defendants' motion to strike and dismiss and for summary judgment is granted. It is so ordered.

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[12] *See, e.g., United States v. Rose*, 590 F.2d 232, 235-36 (7th Cir. 1978), *cert. denied*, 442 U.S. 929, 99 S.Ct. 2859, 61 L.Ed.2d 297 (1978) (legal or factual impossibility of committing offense not a defense to conspiracy claim).

APPENDIX E

No. 82 C 4762

United States District Court
N.D. Illinois, E.D.

Aug. 2, 1985

BEVERLY J. OTTO, Individually and on Behalf of all Others Similarly Situated,
Plaintiffs,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, a Stock Life Insurance Company Organized Under the Laws of the State of Texas, CHARLES T. BAUER, MORTIMER M. CAPLIN, HENRY CHAUNCEY, HARRY C. COPELAND, JR., W. THOMAS FIQUET, FREDERICK M. GLASS, GRINNEL MORRIS, ROY T. PARKER, JR., ROBERT S. PHILLIPS, MICHAEL E. PUYANS, W. DAWSON STERLINE, BENJAMIN N. WOODSON, PHILIP G. DAVIDSON III, ANDREW DELANEY, JOE F. FLACK, RICHARD H. HANNEMAN, HAROLD S. HOOK, MARDEN MILLER, JOHN J. PLUMB, GEORGE F. REED, ROBERT L. BALDWIN, STEPHEN D. BICKEL, TERRENCE J. CONLAN, JOE D. HEUSI, JOHN D. HOGAN, WILLIAM B. PARDUE, WILLIAM C. PHELPS, MICHAEL J. POULOS, ROBERT O. PURCIFULL, DIANE G. D'AGOSTINO, and GREGORY C. WILCOX, Individually Variable Annuity Marketing Company, the VARIABLE ANNUITY LIFE INSURANCE COMPANY SEPARATE ACCOUNT ONE and AMERICAN GENERAL CORPORATION,
Defendants.

MEMORANDUM ORDER

ASPEN, District Judge:

Plaintiff's second motion to reconsider and for leave to amend her complaint is denied.

On April 11, 1985, the Court, 611 F.Supp. 83, granted defendants' motion for summary judgment on Counts I and II and dismissed the remainder of plaintiff's amended complaint. Plaintiff filed her first motions for reconsideration and for leave to file a second amended complaint on April 19, 1985. However, plaintiff filed no proposed second amended complaint at that time. On April 26, 1985, the Court denied plaintiff's motions.

Plaintiff filed the motion now before the Court, her second motion to reconsider and for leave to amend the complaint (along with a copy of the proposed pleading), on May 10, 1985. She also filed that day a notice of appeal to the United States Court of Appeals for the Seventh Circuit from the final judgment entered on April 11, 1985, and the order of April 26, 1985—the two rulings she asks this Court to reconsider.

A.

We first note that although plaintiff claims that her motion comes under Fed.R.Civ.P. 60(b), it is properly viewed as a motion to alter or amend a judgment as allowed under Rule 59(e). Plaintiff essentially asks this Court to correct errors of law; this is not the type of "mistake" referred to in Rule 60(b) but falls within the scope of Rule 59(e). *See, e.g., United States Labor Party v. Oremus*, 619 F.2d 683, 687 (7th Cir. 1980); *Dove v. Codesco*, 569 F.2d 807, 809 (4th Cir. 1978).[1]

Motions under Rule 59(e) must be filed within ten days after entry of judgment, and district courts may not extend this deadline. *Textile Banking Co., Inc. v. Rentschler*, 657 F.2d 844, 849 (7th Cir. 1981). However,

[1] Moreover, plaintiff herself originally treated her motions to reconsider as if they were Rule 59(e) motions. She has acknowledged the Rule's ten-day deadline, both by filing her first motion within that time period and by explaining in her second motion why her counsel was unable to prepare a proposed second amended complaint within ten days after April 11, 1985.

plaintiff did not file her second motion to reconsider within ten days—it came twenty-nine days after the Court's April 11 decision and fourteen days after the April 26 ruling. On this basis alone, plaintiff's motion must be denied.

B.

Defendants also argue that plaintiff's motion should be denied because she divested this Court of jurisdiction over the matter when she filed her notice of appeal on May 10, 1985. In general, the filing of an appeal vests jurisdiction in the court of appeals, and further proceedings in the district court cannot take place without leave of the appellate court. *Asher v. Harrington*, 461 F.2d 890, 895 (7th Cir. 1972). In this case, the Seventh Circuit has ordered that briefing in plaintiff's appeal shall be held in abeyance pending further order of the Court of Appeals, and that plaintiff's counsel is to report to the Seventh Circuit as to this Court's ruling on plaintiff's motion to reconsider. This order might be construed as granting (though not explicitly) this Court leave to proceed further in deciding plaintiff's motion on the merits. More likely, the Seventh Circuit's order expresses no opinion on the question and leaves it to this Court to decide whether or not it has jurisdiction over plaintiff's motion any longer. If the latter be the case, we agree with defendants that plaintiff's appeal has vested jurisdiction solely in the Seventh Circuit.

Under Fed.R.App.P. 4(a)(4), a notice of appeal has no effect if it is filed before disposition of a timely post-trial motion (including one under Fed.R.Civ.P. 59). However, as explained in Part A above, plaintiff's motion was not timely—it was filed more than ten days after the entry of judgment. *See* 6A J. Moore, Moore's Federal Practice ¶ 59.13[3] (2d ed. 1984). Plaintiff's notice of appeal is therefore effective and divests the Court of jurisdiction.

Moreover, the pending motion seeks reconsideration of the Court's order denying plaintiff's first motion to reconsider. A *second* motion to reconsider should not be deemed a timely Rule 59 motion, even if filed within ten days (which is not the case here). 9 J. Moore, Moore's Federal Practice ¶ 204.12[1] (2d ed. 1985) ("Both the text and purpose of Rule 4(a)(4) indicate that it is an *original* motion of the types specified that postpones appeal until after disposition of the motion and the running of the time for appeal is not further extended by a motion to reconsider an order disposing of the motion. . . .") (footnote omitted and emphasis in original). Because plaintiff filed an effective appeal, her second motion to reconsider must be dismissed for lack of jurisdiction.

C.

Even if plaintiff's motion were timely and this Court had not been divested of jurisdiction by plaintiff's notice of appeal, the motion should be denied. Nothing in plaintiff's motion or memoranda convinces us that our earlier rulings were in error.

Our decision that the fixed annuity in this case should not be deemed a security is not contradicted by the Seventh Circuit's holding in *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984). *Hunssinger* involved the purchase of notes by a profit sharing trust, not the purchase of a fixed annuity. This distinction is significant: "note" is the first term listed in the statutory definition of security, 15 U.S.C. § 78c(a)(10), while an "annuity contract" issued by a regulated insurance company is considered to be an exempted security, 15 U.S.C. § 77c(a)(8).[2] Moreover, the Seventh Circuit's

[2] The Court of Appeals stated that "an instrument that does not pass the investment contract test may still be a security if it falls under one of the other specific statutory terms." *Hunssinger*, 745 F.2d at 491. "Note" is one such statutory term; "annuity" is not.

decision was based on the repeated reference to the note as an investment and on the district court's failure to look beyond the document and consider the facts surrounding the promotion and purchase. Contrary to plaintiff's assertion, this Court did indeed consider "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect," *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 211, 87 S.Ct. 1557, 1562, 18 L.Ed.2d 673 (1967), in deciding that defendants' fixed annuity was more akin to an insurance product than an investment contract.

Plaintiff's contention concerning her ERISA count merits little response. She cites no authority supporting her claim that our holding necessarily affects the tax deductibility of payments for the fixed annuity, and we do not see the logic of her position. Two different statutes with different purposes are involved; our holding that the fixed annuity plan is not "established or maintained" by plaintiff's employer for the purposes of ERISA should have no effect on the status of her payments under the Internal Revenue Code.

Once more, we decline to reconsider our application of Rule 9(b) to Counts III and IV. Plaintiff's first amended complaint is distinguishable from the complaint we considered in *Swanson v. Wabash, Inc.*, 577 F.Supp. 1308 (N.D.Ill. 1983), and in fact is more similar to those found to be insufficient in *D & G Enterprises v. Continental Illinois National Bank and Trust Co. of Chicago*, 574 F.Supp. 263 (N.D.Ill. 1983), and *Lincoln National Bank v. Lampe*, 414 F.Supp. 1270 (N.D.Ill. 1976). Thus, plaintiff's second motion to reconsider is denied in its entirety.

D.

Plaintiff's second motion for leave to file another amended complaint should also be denied.

First, plaintiff incorrectly claims that she has satisfied all the requirements set forth by the Seventh Circuit in the recent case of *Twohy v. First National Bank of Chicago*, 758 F.2d 1185 (7th Cir. 1985). The Court of Appeals in *Twohy* explained the different standards governing post-judgment and pre-judgment amendments of a complaint: although even after entry of judgment on dismissal "leave [to amend] shall be freely given when justice so requires," Fed.R.Civ.P. 15(a) "justice may require something less in post-judgment situations." *Id.* at 1195-96. The Seventh Circuit repeated its previous holding that

> once a district court enters judgment upon a dismissal (as opposed to a mere dismissal of the complaint), the plaintiff may amend the complaint under Rule 15(a), Fed.R.Civ.P., solely with "leave of court" after a motion under Rule 59(e) or 60(b), Fed.R.Civ.P., has been made and the judgment has been set aside or vacated. *Car Carriers, Inc. v. Ford Motor Co.*, 745 F.2d 1101, 1111 (7th Cir. 1984), *cert. denied*, —— U.S. ——, 105 S.Ct. 1758, 84 L.Ed.2d 821 (1985). The right under Rule 15(a) to amend "once as a matter of course" is lost after the entry of judgment. *Id.*

Id. at 1196. As explained in Parts A-C above, plaintiff's motions to reconsider have been denied. Because the judgment has not been set aside or vacated, plaintiff may not amend her complaint again. Moreover, like the plaintiff in *Twohy*, plaintiff failed to file a proposed amended complaint with her first Rule 59(e) motion to amend the judgment order and request for leave to file an amended complaint.[3] Thus, plaintiff did not comply with the re-

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[3] Plaintiff's explanation of how busy her counsel was is unavailing. Twenty-nine days passed between the entry of judgment and the filing of a proposed second amended complaint, and the Seventh Circuit has stated that a failure to tender a proposed pleading

quirements for post-judgment amendments described in *Twohy*.

Second, plaintiff's proposed second amended complaint is not offered in good faith. In our April 26, 1985 order denying plaintiff's first motion to amend, we noted that plaintiff not only failed to attach a proposed pleading but also that she

> suggest[ed] that her second amended complaint would respond to "only the *first* motions attacking the Complaint." While it is not clear just what plaintiff intends by this qualification, an amended complaint which disregarded some of defendants' motions and/or this Court's rulings on such motions would not even constitute a good faith effort by plaintiff.

Notwithstanding this admonition, plaintiff repeated her cryptic qualification in her second motion to reconsider and for leave to amend. Motion ¶ 7.

Plaintiff has also failed to conform her proposed second amended complaint to this Court's earlier rulings in several other ways. For example, the proposed complaint lists three individuals besides Otto as named plaintiffs and class representatives in spite of the fact that this Court clearly denied Otto's motion to add them as parties. April 11, 1985 at 88 n. 10. Although the Court certified a class of all Illinois fixed annuity participants between October 17, 1975 and August 2, 1982, plaintiff purports to expand the class beyond June of 1984. Neither Counts I nor II conform in the least to the Court's summary judgment rulings. Count III, among other things, names the same corporation as the liable "person" and the "enterprise" under 18 U.S.C. § 1962(c), although this Court earlier made it clear that this was

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with a Rule 15(a) motion to amend "certainly indicates a lack of diligence and good faith." *Twohy*, 758 F.2d at 1197 (footnote omitted).

impermissible. April 11, 1985 at 89. These blatant deviations (and others) from the Court's prior decisions in this case demonstrate a lack of good faith which justifies denying plaintiff's second motion to amend.

Third, once a motion to dismiss (or for summary judgment) has been granted, the district court need not allow an amendment that does not cure the defects of the original complaint. *Textor v. Board of Regents of Northern Illinois University*, 711 F.2d 1387, 1391 n. 1 (7th Cir.1983); *Stebbins v. Weaver*, 537 F.2d 939, 942 (7th Cir.1976), *cert. denied*, 429 U.S. 1041, 97 S.Ct. 741, 50 L.Ed.2d 753 (1977); *see also Verhein v. South Bend Lathe, Inc.*, 598 F.2d 1061, 1063 (7th Cir.1979) (court may deny leave to amend where proposed amendment fails to allege facts which would support a valid theory of liability or where moving party has not shown that proposed amendment has substantial merit).

In Count I, plaintiff has simply stopped calling three documents the "Fixed Annuity Plan" and begun referring to them instead as the "Tax Deferred Investment Program." This change in labels, however, does nothing to alter the Court's analysis of the documents themselves or the law relating to them. Also added to plaintiff's securities claim is an alleged § 10(b) violation concerning the tax status of the annuities (in light of this Court's decision regarding ERISA). As stated above, we find this argument of plaintiff's to be illogical; it does not support a valid theory of liability. *Verhein*, 598 F.2d at 1061.

Similarly, plaintiff's proposed Count II alleges no new facts which would require the Court to reconsider its earlier decision. *Stebbins*, 537 F.2d at 942.

Counts III and IV still suffer the same deficiencies as before. Although plaintiff names VAMCO as the enterprise, she uses this label inconsistently. We have already noted that VAMCO is improperly named as both the

enterprise and person liable. Moreover, plaintiff suggests in her supporting memorandum that the "VALIC family" or the "American General Family" are the true enterprises in this case. The second amended complaint proposed by plaintiff also is still wholly insufficient in pleading with the specificity required by Fed.R.Civ.P. 9(b) the involvement of each defendant in any fraudulent activity. The inclusion of several documents purported to be instances of mail fraud does not cure this defect. Likewise, Count IV fails to allege a conspiracy claim against any of the particular defendants.

Because plaintiff is not entitled to post-judgment amendment as explained in *Twohy*, and because the proposed second amended complaint is not offered in good faith and would be futile, plaintiff's second motion for leave to amend her complaint is denied.

Plaintiff's second motion to reconsider and for leave to amend her complaint is denied on three bases: (1) the motion is untimely; (2) plaintiff's notice of appeal divests this Court of jurisdiction; and (3) the motion should be denied on the merits. It is so ordered.

APPENDIX F

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60064

April 15, 1987

Before

HON. WILLIAM J. BAUER, *Chief Judge*
HON. RICHARD D. CUDAHY, *Circuit Judge*
HON. KENNETH F. RIPPLE, *Circuit Judge*

Nos. 85-1816, 85-1919, and 85-2410

BEVERLY J. OTTO, individually, and
on behalf of all others similarly situated, *et al.*,
Plaintiffs-Appellants,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,
Defendants-Appellees.

Appeals from the United States District Court for the
Northern District of Illinois, Eastern Division

No. 82 C 4762—Marvin E. Aspen, Judge

AMENDED JUDGMENT ORDER

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED IN PART, REVERSED AND REMANDED IN PART, in accordance with the opinions of this Court of December 8, 1986 and April 15, 1987. Costs on appeal are awarded to plaintiffs-appellants.

APPENDIX G

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60064

June 15, 1987

Before

HON. WILLIAM J. BAUER, *Chief Judge*
HON. RICHARD D. CUDAHY, *Circuit Judge*
HON. KENNETH F. RIPPLE, *Circuit Judge*

Nos. 85-1816, 85-1919, and 85-2410

BEVERLY J. OTTO, individually, and
on behalf of all others similarly situated, *et al.*,
Plaintiffs-Appellants,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,
Defendants-Appellees.

Appeals from the United States District Court for the
Northern District of Illinois, Eastern Division

No. 82 C 4762—Marvin E. Aspen, Judge

ORDER

On consideration of the petition for rehearing *en banc* filed by the defendants-appellees in the above-entitled cause, no judge in active service has requested a vote thereon. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing *en banc* be, and the same is hereby, DENIED.

APPENDIX H

1. Section 3(a)(8) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(8), provides:

> (a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:
>
> * * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

2. Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) provides:

> (a) When used in this chapter, unless the context otherwise requires—
>
> * * * *
>
> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any

instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

3. Sections 1 and 2 of the McCarran-Ferguson Act, 15 U.S.C. §§ 1011 and 1012, provide:

§ 1011

Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

§ 1012

(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided*, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal

Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

4. SEC Rule 151, 17 C.F.R. § 230.151, 51 Fed. 20,254, 20,262 (June 4, 1986), provides:

> (a) Any annuity contract or optional annuity contract (a "contract") shall be deemed to be within the provisions of section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)), *Provided*, That
>
> > (1) The annuity or optional annuity contract is issued by a corporation (the "insurer") subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;
> >
> > (2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this section; and
> >
> > (3) The contract is not marketed primarily as an investment.
>
> (b) The insurer shall be deemed to assume the investment risk under the contract if:
>
> > (1) The value of the contract does not vary according to the investment experience of a separate account;
> >
> > (2) The insurer for the life of the contract
> >
> > > (i) Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and
> > >
> > > (ii) Credits a specified rate of interest (as defined in paragraph (c) of this section) to

net purchase payments and interest credited thereto; and

(3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b) (2) (ii) of this section will not be modified more frequently than once per year.

(c) The term "specified rate of interest," as used in paragraph (b) (2) (ii) of this section, means a rate of interest under the contract that is at least equal to the minimum rate required to be credited by the relevant nonforfeiture law in the jurisdiction in which the contract is issued. If that jurisdiction does not have any applicable nonforfeiture law at the time the contract is issued (or if the minimum rate applicable to an existing contract is no longer mandated in that jurisdiction), the specified rate under the contract must at least be equal to the minimum rate then required for individual annuity contracts by the NAIC Standard Nonforfeiture Law.

APPENDIX I

SUPREME COURT OF THE UNITED STATES

No. A-171

VARIABLE ANNUITY LIFE INSURANCE COMPANY *et al.*,
Applicants,

v.

BEVERLY J. OTTO, ETC.

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for the applicants,

IT IS ORDERED that the time for filing a petition for a writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including October 13, 1987.

/s/ John Paul Stevens
Associate Justice
of the Supreme Court
of the United States

Dated this 28th day of August, 1987.

APPENDIX J

American General Corporation owns the following subsidiaries, which are involved in the joint ventures listed below:

AGC Resources, Inc.
- Highland Resources, Inc.

American General Corporation
- Woodham Joint Venture

American General Investment Corporation
- Appelt Prop. No. 1, Ltd.

American General Life & Accident Insurance Company
- Fulcrum II, L.P.
- Institutional Venture Partners, L.P.
- Institutional Venture Partners II, L.P.
- Morgan Stanley Leveraged Mezzanine Fund, L.P.

American General Life Insurance Company
- American General Health Club

American General Life Insurance Company of Delaware
- America Tower
- Cypress Crossing Venture
- Mosbacher—A. G. Company

American General Life Insurance Company of New York
- Highland Resources, Inc. 1984
- One Park Place Associates

American General Realty Company
- Allen Center Co.
- Allen Center Co. #2
- Allen Center Co. #3

Atlas Realty Company
- Charter Associates

Cinco Ranch Venture
Cutten Associates
Cypress Associates
Deer Valley Industrial Center
Encanto Business Park
Hickory Down Venture
Langham Associates
The Meadows Venture
One Arlington Center
Pecan Grove Associates
Treaschwig Associates

California-Western States Life Insurance Company
America Tower
Cal-Mira Mesa, Ltd.
Cal-Sorrento, Ltd.
Sunrise Mall Associates
Vagabond Glendale Motor Hotel
Vagabond Sunnyvale Motor Hotel
Warburg-Pincus LTD.

Georgetown Realty, Inc.
Lake Wylie

Gulf Village, Inc.
Wharfside II

Gulfco Capital Management, Inc.
Soujourn/Westgrove Off/Serv. Bldg.

Hadco, Inc.
Columbia Square
Duo Mercatum

Intereal Company
Boone-Southern
Carlton Arms of Egypt Lake
Hickory Hollow Associates
Koll/Intereal Bay Area
Koll/Intereal Northwest
Koll/Intereal Phoenix

Koll/Intereal Portland
Koll/Irvine Business Center
Koll National
Koll National Cypress
Koll National North
Newmarket North
Newmarket South
Norcal Associates
Sammis Diamond Bar II
Sammis Diamond Bar III
Santa Fe Springs Business Park
West Georgia Common Associates
West Lake Arms

Jovencal Realty, Inc.
Kollreal
Oak Meadows Properties

Joventex Corporation
Camino Real Apartments
Cinco Venture

Life and Casualty Insurance Company of Tennessee
Alamo II
America Tower
American General Health Club
No. 1 Beach Street

Rylis Realty Company
Columbia 205 Commerce Center
Fairbanks Associates
Glencairn Village
Jackrabbit Venture
Overlake Commercial Center
Riverbrook Associates

Tennessee Vintage Corporation
Vintage Faire Associates

Supreme Court, U.S.
FILED
DEC 16 1987
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CLERK

(5)

No. 87-600

In The
Supreme Court of the United States
October Term, 1987

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,

Petitioners,

v.

BEVERLY J. OTTO, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, *et al.*,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF RESPONDENTS IN OPPOSITION

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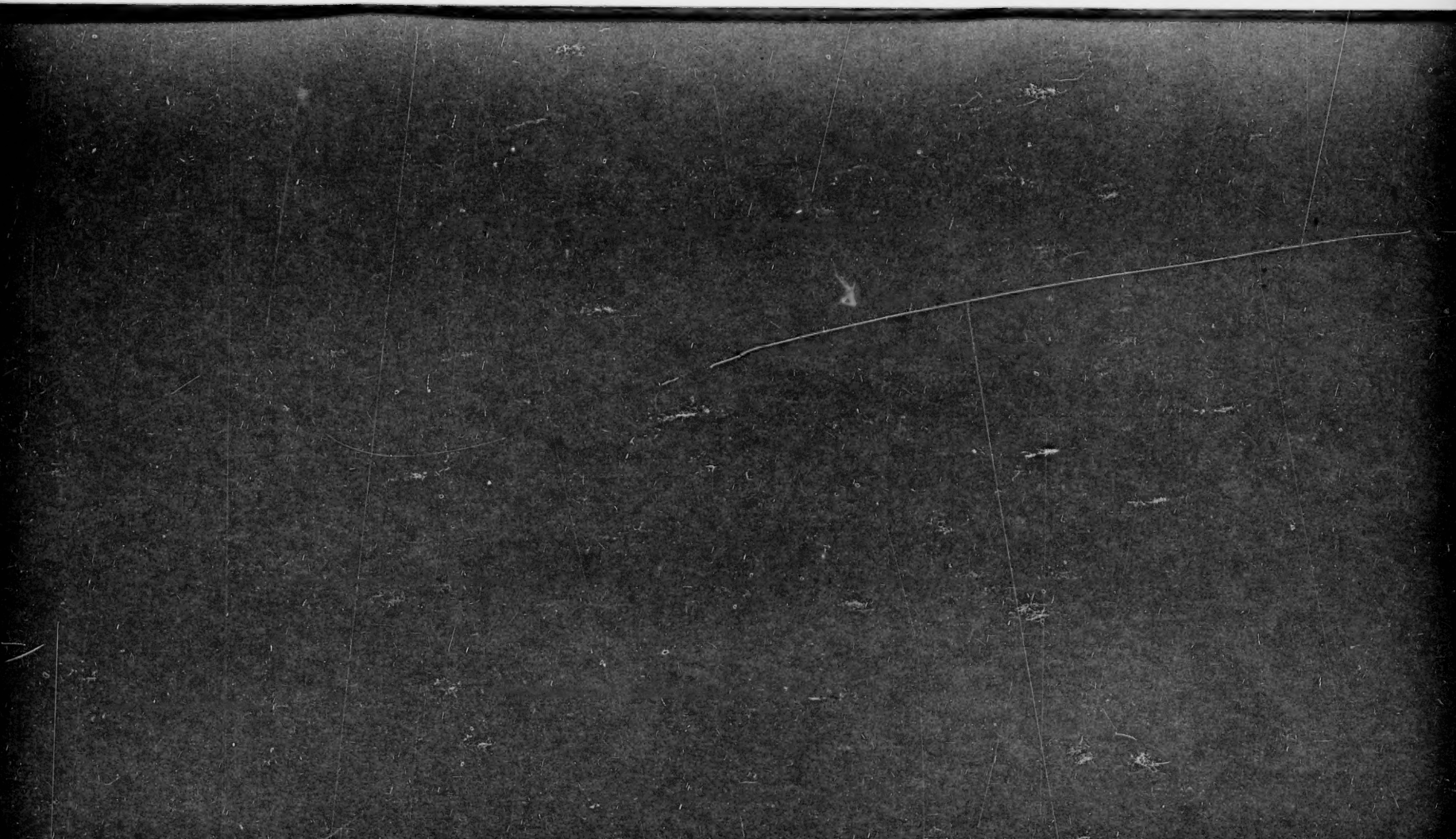

QUESTION PRESENTED

Whether the VALIC fixed annuity plan which is sold as a combination contract with an SEC registered security, the variable annuity, under the heading "A Tax Deferred Investment Program" consisting of a plan:

a) under which the investor bears the investment risk under SEC guidelines;

b) specially designed with unique investment features such as the option to freely switch back and forth from fixed to variable accumulation accounts;

c) which is not a traditional stand alone fixed annuity paying below market interest;

d) not regulated by the State of Illinois;

e) marketed with emphasis on discretionary competitive excess interest; and

f) sold by members of the National Association of Securities Dealers, not by insurance salesmen,

is a security subject to the coverage of the federal securities laws.

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OPINIONS BELOW

The opinions below are unanimous, both originally and on rehearing. There was no dissent nor was VALIC's In Banc rehearing granted.

In addition to the opinions listed by the petitioners, the order of the Court of Appeals dated January 29, 1987 is attached as Appendix A. This order, with its findings and directives, is as integral to the case on appeal as the opinions.

———o———

STATEMENT OF THE CASE

This is a certified class action, the members of the class being all Illinois investors who participated in VALIC's fixed annuity plan/program. The Court of Appeals found that VALIC had misled (i) its customers (the plaintiffs herein); (ii) the district court; and (iii) the Court of Appeals. (For a discussion of the misrepresentations by VALIC see App.A.) It held that VALIC's "fixed annuity plan" was a security subject to the federal securities laws (814 F.2d at 1141). Defendants-Respondents are petitioning for certiorari as to this holding.

Plaintiffs-Respondents. The class that the named Plaintiffs represent is primarily comprised of school teachers, janitors, nurses, and other employees of non-profit institutions who invested funds in VALIC's "Tax Deferred Investment Program", of which the fixed annuity plan is a part. The program is tailored both to this particular class of buyers and to their use as retirement vehicles. The Plaintiffs-Respondents will be collectively referred to hereafter as "Otto," the first of the named Plaintiffs.

Defendants-Petitioners. The principal corporate Defendants are Variable Annuity Life Insurance Company (VALIC), an underwriting company, and VALIC's marketing subsidiary, Variable Annuity Marketing Company (VAMCO). VALIC is the same company whose variable annuity was held to be a security in *SEC v. Variable An-*

nuity Life Insurance Company, 359 U.S. 65 (1959) ("VALIC I"). The variable annuity, which was the only product sold by VALIC in 1959, is the backbone of the "Tax Deferred Investment Program" that is the subject of this litigation. The fixed accumulation account or fixed-annuity which the plaintiffs invested in was appended to the program in 1964. The Defendants-Petitioners will be collectively referred to hereafter as "VALIC," though, depending on the context, that name will also be used to identify only the Variable Annuity Life Insurance Company.

VALIC is in the business of issuing, among other things, an investment program which they have entitled a *Tax Deferred Investment Program.* The program was sold in Illinois by the marketing subsidiary of VALIC, VAMCO. VAMCO was not subject to regulation by the State of Illinois Department of Insurance as it was not licensed to do so. (By VALIC's own admission, its representatives should have been licensed.) (Pet., p. 4.) (VAMCO did not even qualify to do business in the state, though required to do so). Since the variable accumulation account is a security, all VAMCO sales people who sold the program had to be licensed National Association of Securities Dealers ("NASD") members. The class invested in this plan, with some class members allocating all their contributions to the "fixed annuity," and others pursuant to a VALIC option, splitting their contributions between the "fixed annuity" and the "variable annuity." Some class members actively switched their contributions between the two annuities.

Misrepresentations by VALIC concerning "banding of interest" and discretionary interest on "fixed annuity" deposits are the basis of this litigation.

Tax deferred plans. VALIC's investment program was designed to meet the special requirements of Section 403(b) of the Internal Revenue Code. Under this section, employees of public schools, private colleges, hospitals

and exempt charitable or educational organizations are able to put aside funds for retirement just as a profit sharing plan does in a profit making company. The Code permits employee funds to be invested in three types of accounts: mutual funds, custodial accounts, and annuity accounts. The investment contract sold by VALIC was designed to fall into the annuity category, although no traditional annuity was involved, only a deposit of funds for investment with and by VALIC.

The Tax Deferred Investment Program issued by VALIC is divided into two phases. In the first phase—the accumulation phase—the employee pays money to VALIC. This normally takes place through weekly or monthly withholding from his salary and the payment of the withheld amount to his account with the program manager, in this case VALIC. The funds were invested with VALIC, pursuant to its representation that it would pay the "highest current interest available" on all "fixed annuity" deposits.

Upon withdrawal from the plan for any reason—retirement, change of employer, or even because of a simple need for the money standing to his credit—the employee enters the second phase. In phase two—the pay-out phase—the accumulated amount is directed toward some end. In the VALIC program, either variable or fixed, the investor has four options. He can direct VALIC to (i) pay him the full amount; (ii) pay the full amount to the employee's IRA; (iii) continue to hold the funds and keep them invested; (iv) invest the funds in one of a variety of VALIC annuities. In other words, even if the investor throughout his earning years had allocated all his funds to the fixed accumulation account he could, on retirement, select the variable annuity, a security.

Prior to the purchase of an annuity by a participant, the relationship between VALIC and the investor was that of debtor and creditor. As stated by VALIC in its handbook (R.52, Ex.B):

> "Should you find it necessary to surrender your contract in the Fixed Account, VALIC guarantees to return the greater of the total cash value of your Fixed Account or your total contributions to the Fixed Account, less any prior withdrawals."

The mechanics of these programs are important for an understanding of this case.

VALIC's Description of its Fixed Annuity Plan. The foregoing described the VALIC investment program that is the subject of this litigation. VALIC has misrepresented its product to the court because it calls the fixed accumulation account of the "Tax Deferred Investment Program" a "traditional fixed annuity." (Pet., p. (i), passim) Not one of those terms is accurate. It was not an annuity; none of the named Plaintiffs ever received an annuity and it is doubtful that any member of the class did. It was not fixed; the amount of annuity depended on the amount contributed and on the earnings from the contributions—these earnings being almost totally within the investment discretion of VALIC, and on VALIC's unfettered discretion as to the amount of interest it would pay. It was not "traditional;" not only was it tailored to the specific requirements of the Internal Revenue Code for the unique use of schools, colleges, and other nonprofit organizations, but it contained an option to convert the contract from a return based on interest to a variable return based on market performance of investments. Such option on a security is itself a security (see Point B-1 of this brief). It did not resemble a traditional annuity at all.

In fact, VALIC admits in its Petition that the "traditional" fixed annuity that guarantees principal and a specified return without "excess interest" is rarely sold in the market today (Pet., p.19). As VALIC states in its Petition (at footnote 8 on page 18): "The fact that fixed annuities guarantee interest that is below market rates of return is thus an integral feature of this insurance product." VALIC did not sell the "traditional fixed an-

nuity" that it describes in its Petition. VALIC's literature describes its product as providing the "highest current interest available" (R. 174, Ex.I) and as an investment.[1] This is hardly the "traditional fixed annuity" marketed with below market interest rates they describe in the Petition, but rather an investment contract or type of money market account.

The VALIC Accumulation Accounts. During the accumulation phase a VALIC investor was given an option as to the investment of his funds. He could invest in the so-called "fixed" account or in the variable account (an admitted security), or in any combination of the two. Further, he could, without penalty, freely switch his funds from the fixed to the variable or from the variable to the fixed, and back again. As stated in the "Owner's Manual," (R. 52, Ex.B):

> "A Flexible Contract—Prior to retirement, you may exercise your option at any time to transfer any or all of your cash value from the fixed accumulation account to the variable accumulation account, or vice-versa, as the priorities of your total investment picture may change."

While funds invested in the "fixed" accumulation account were guaranteed an initial return of 4% a year, later dropping to 3½%, the real incentive was the *extra* interest that VALIC, in its unfettered discretion, could pay on the funds in the fixed accumulation account, as the Court of Appeals stated:

> "But VALIC's argument directly under the statute depends on its assertion that the guaranty of return here requires calling the instrument insurance under sec. 3(a)(8) *even if the prospect of 'excess' interest*

---

[1] The Owner's Manual issued by VALIC emphasizes the investment results of the program: "Your funds are managed by investment managers who have the training, time, experience and necessary tools to manage your money professionally." "You may leave funds on deposit where they will continue to experience the appropriate investment result . . ." (R. 52, Ex.B).

is a principal inducement to purchase this particular instrument." (814 F.2d at 1142, emphasis added).

As VALIC notes in its Petition, a traditional "fixed annuity" has only a low guaranteed rate of interest which is below market because: "Such a limitation ensures that the guaranteed rate does not exceed what can be safely and reliably maintained over the life of the annuity." (Pet., p.18, footnote 8). In other words, a traditional fixed annuity which is rarely sold today imposes no investment risk on the issuer. During the period covered by this litigation, comparable investments were paying 8% to 14.5%; the guaranteed return of 4% was a poor incentive to choose a VALIC contract—unless the offer was coupled with a bonus, in this case, extra interest. VALIC offered that extra interest. It had to in order to be competitive for consumer dollars. In fact its fixed annuity plan can be characterized as a money market fund issued by an insurance company in direct competition with all other such investments. Though this was called a "fixed" account, in reality the return on it was almost as variable as the variable account itself.

VALIC sold its fixed annuity and variable annuity as one product. The selling literature and the documents relating to the investment program treated the fixed and the variable accounts as part of the same instrument. Separate documentation was not used for each type of account, since each account was freely convertible into the other. VALIC used the same confirmation which listed amounts allocated to both the fixed account participants and the variable account participants.

The Proceedings Below

Otto's complaint alleged causes of action under six counts: the Securities Act of 1934 for damages, not rescission, since rescission would not provide relief to the class for the failure to pay the interest VALIC had advertised it was paying; ERISA; RICO, conspiracy; common law fraud; and breach of contract. The district court

dismissed or granted summary judgment for VALIC on Otto's federal counts even though discovery and an opportunity to amend had both been denied.

Based on misleading representations (later found false) made by VALIC, the Court of Appeals initially affirmed the lower court. Otto then filed a Petition For Rehearing With Suggestions For Rehearing In Banc, pointing out in detail where VALIC had misled both the district court and the Court of Appeals. Otto would like to feel that the persuasiveness of her argument alone caused the court to reverse itself, but this may be incomplete. She had the assistance of VALIC's confession that it had misled the court.

After reviewing Otto's Petition for Rehearing and VALIC's confession of error, the Court requested further briefs and stated as follows in its order of January 29, 1987 (App. A):

> "Because VALIC's omission apparently involves a fact central to the analysis of a close question, VALIC's failure to disclose and subsequent motion to modify force this court to waste valuable judicial resources and may call for sanctions as well as possibly affecting the result." (p.4)

After filing of additional briefs on the issue of investment risk, the Court reversed as follows:

> "Upon reexamination in light of VALIC's newly asserted right to alter past interest bands, we hold that VALIC's fixed annuity plan is a security subject to the federal securities laws." (814 F.2d at 1141)

———o———

REASONS FOR DENYING THE PETITION

A. The Opinion of the Court of Appeals Does Not Conflict With Any Other Circuit, Any Prior Supreme Court Decision, The Standards Of The SEC, Will Not Have Immediate Or Widespread Consequences, Is Interlocutory In Nature, And Is Consistent With The McCarran-Ferguson Act And Other Regulatory Schemes.

1. The Opinion Does Not Conflict With Prior Decisions Of The Supreme Court Or Any Other Circuit.

The only circuit case VALIC lists as conflicting with the holding in the case at bar is *Olpin v. Ideal National Insurance Company,* 419 F.2d 1250 (10th Cir. 1969), cert. denied, 397 U.S. 1074 (1970). VALIC's reliance on *Olpin* is misplaced. *Olpin* involved a whole life insurance policy issued by a mutual company regulated by the state. In fact, in *Olpin* the Commissioner of Insurance for the state of Utah, based upon an opinion of the Attorney General that the Endorsement in question was void under the law of Utah, had approved various methods for the insurance company to return the premiums it had charged for the Endorsement (419 F.2d at 1252-3). *Olpin* did not involve providing the policy holder with an option to purchase a security; did not involve the hyping of excess interest; and was decided before SEC Release 6051 was issued in 1979 and SEC Rule 151 was adopted (1986). In oral argument VALIC admitted that the payments made by a mutual company to its policyholders are not similar to the discretionary interest payments in the case at bar (Oral Argument Transcript, p.14). In short, *Olpin* is no support for VALIC in the case at bar. Moreover, some eight years later it was not followed in *Grainger v. State Security Life Ins. Co.,* 547 F.2d 303, reh. denied, 563 F.2d 215 (5th Cir. 1977), cert. denied, 436 U.S. 932 (1978), which found a product similar to VALIC's fixed annuity a security.

It is significant that nowhere does VALIC claim a conflict with any court decision decided after SEC Release 6051 was issued in 1979. There is good reason for this. *No new law was established by the Court of Appeals here in its final decision.* The "traditional" securities-insurance cases have all been left untouched.

VALIC argues that its guarantee of 4% interest shifted the investment risk enough to qualify under Section 3(a)(8). The argument has been rejected by both the SEC (Release 6645) and the *Otto* Court of Appeals (814 F.2d at 1141-1142). The holding in the case at bar follows the teachings of the SEC and prior precedents of the 7th Circuit and this Court. In *Peoria Union Stock Yards Co. v. Penn Mutual Life Insurance Co.*, 518 F.Supp. 1302, 1306 (N.D.Ill. 1981), the opinion of the trial court found that the rate of interest credited on deposits made for the first three years of the contract was guaranteed at a rate of 7.5% and thereafter ultimately reduced to 3.5%. In commenting on the guarantee, Judge Posner in *Peoria Union Stock Yards Co. v. Penn. Mut. Life Ins. Co.*, 698 F.2d 320, 325 (7th Cir. 1983), first referred to the guarantee in the *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), as a point of comparison and stated that:

> " '*United* set its guarantee by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so that it would not have become operable under any prior conditions.' 387 U.S. at 209 n. 12, 87 S.Ct. at 1561 n.12. The minimum in the present case was even lower; . . ."

The *Peoria* court, in commenting that after the first three years of contributions the amount of interest was at the discretion of the insurance company, stated as follows:

> " . . . it was nonexistent for contributions made after the third year." (698 F.2d at 325)

In the case at bar, VALIC only guaranteed 4% interest for the first ten years of the contract and 3½% thereafter. The Court of Appeals followed prior precedent because the

guarantee given by VALIC is even less than the guarantee given by Penn Mutual discussed in the *Peoria* case (*supra*) and less than the guarantee in the *United Benefit* case (*supra*).

In short, the court merely applied the existing law relating to the securities-insurance dichotomy to the facts at hand. It added nothing new or extraordinary and is in accord with the case law, the SEC releases and SEC Rule 151.

2. The Opinion Does Not Conflict With SEC Rules Or Regulations Nor Has The SEC Filed An Amicus Brief In This Case.

Rule 151 was the banner waved by VALIC right up to the time the Court of Appeals reversed itself and held that VALIC did not comply with the rule. When faced with that outcome, VALIC now protests that the case should not turn on the objective investment risk test of Rule 151. Of all the grounds for holding the investment contract to be a security, Rule 151 was the most favorable for VALIC.

a. The Requirements Of Rule 151 Are The Most Liberal Of Any Previously Used By The SEC.

Otto points out that the great emphasis in this case on Rule 151 has come about because of VALIC's actions. As the Court stated:

> "Since Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC." (814 F.2d at 1142)

Of all the grounds available to VALIC for arguing that the investment products sold by it was insurance, none was so favorable as Rule 151. That rule, therefore, received a starring role in VALIC's briefs and arguments.

The SEC originally initiated an inquiry into annuities preparatory to issuing regulatory guidelines on June 23, 1977 (Release 5838). The insurance industry responded through its executives, attorneys and paid spokesman Pro-

fessor Louis Loss who VALIC now cites as authority throughout its Petition.[2] On May 17, 1978, the SEC issued Proposed Rule 154 (Release 5933) which in effect stated that all contracts such as the one in the case at bar were securities. After public comment, the SEC withdrew Proposed Rule 154 and issued Release 6051 (June 5, 1979) which required the insurer to have both a meaningful mortality and investment risk to qualify as exempt under Section 3(a)(8). VALIC does not qualify under either standard.

On November 21, 1984, the SEC then proposed Rule 151 in its Release 6558 and again after receiving comments from the insurance industry and taking two years consideration, the SEC further watered down its stand and issued Rule 151, which eliminated the mortality risk. In reviewing the conflicting positions taken in response to Release 6558, the SEC adopted the one year requirement [Rule 151(b)(3)] stating, "Designing a 'safe harbor' rule is essentially a matter of balancing the legitimate interests of flexibility in structuring insurance products against the need to provide adequate investor protection." (Release 6645, p.21) In summary, after retreating from its original position that all excess interest instruments were securities, the SEC has determined that unless a contract guarantees the excess rate of interest for a minimum of one year the purchaser/investor has the investment risk.

The determination of the SEC as to when the investor shoulders the investment risk should be given considerable weight. *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-19 (1975). VALIC has admitted that they fail the SEC's objective investment risk

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[2] The court should be advised that Professor Loss has for some years been special counsel to the American Council of Life Insurance which has filed an Amicus Brief in this cause (L. Loss, *Fundamentals of Securities Regulation* (1983) at p. 213, footnote 1).

test of Rule 151 and the opinion in this case has confirmed the SEC's judgment.

Rule 151 is specific as to what is meant by assuming the investment risk under a contract. Among the requirements is that VALIC not be able to modify the rate of excess interest it pays more often than once a year (Rule 151b(3)). After being forced to file a new brief by the Court of Appeals on just the issue of what rights VALIC had to change the rate of excess interest it paid, and after admitting in its brief that it had the right to change the rate of excess interest daily, the Court of Appeals reversed. In reality, VALIC met none of the requirements of Rule 151 (see Point C-1 of this brief).

b. Objective Investment Risk Test Of Rule 151.

A primary focus of VALIC's Petition is that the Court's opinion is based on a new element: Section (b)(3) of Rule 151. Section (b)(3) of Rule 151 is an objective test, as determined by the SEC, as to when the investment risk shifts from the participant to the insurer, that being when the insurer guarantees that the excess interest rate will remain in effect for at least one year. In summarizing the prior case law and SEC regulations and rules, the opinion states:

> "As discussed in our previous opinion, the Supreme Court, this circuit, and the Securities and Exchange Commission (the 'SEC') all have found that the degree of investment risk assumed by the insurance company is an important factor in determining whether a particular annuity plan is an insurance product or a security." 814 F.2d at 1141.

In discussing the standards of Rule 151 the opinion stated as follows:

> "The SEC recently enacted Rule 151 which defines more precisely what constitutes sufficient investment risk-taking by an insurance company to ensure that an annuity will be considered an insurance product

> and exempt from federal securities laws pursuant to section 3(a)(8) of the 1933 Securities Act." *Id.*

And the Court held as follows:

> "A claimed right to change established excess interest rates and to eliminate excess interest payments entirely *at any time* surely tends to shift the investment risk from VALIC to the plan participant." *Id.* (emphasis added)

As the Court of Appeals recognized, if any investment risk to VALIC looked likely to occur all VALIC needed to do to eliminate its risk was lower the interest it paid on past "bands" as it did in December, 1983 (see R.131, lowered interest rate on past contributions).

VALIC had convinced the Court of Appeals that the investment risk test of Rule 151 was the guiding star. After doing so it had to confess that it could not meet the objective investment risk test of Rule 151. VALIC picked the arena in which it wanted to play; after losing, it then claimed it was the wrong arena. But as the Court said in its modified opinion, "Since Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC. We therefore find that VALIC's fixed annuity plan is a security." 814 F.2d at 1142.

c. VALIC Fails The Tests Of SEC Release 6051.

VALIC has admitted it fails the objective investment risk test of Rule 151. Although not discussed in the opinion, the policy of the SEC prior to Rule 151 and the policy in effect and which governs this case is Release 6051. This policy required both an investment risk and a mortality risk in order to be an exempt annuity.[3]

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[3] The SEC on April 5, 1979 issued its "General Statement of Policy" (Release No. 6051) giving the factors which differentiate a "security" from an "annuity" or "insurance product". Release 6051 provides as follows:

(Continued on following page)

The VALIC fixed annuity plan has no mortality risk. If an investor dies before purchasing an annuity or withdrawing his money all he obtains is his principal and the interest it earned. There is no mortality risk on VALIC.

VALIC states that its guarantee of 4% interest should qualify it as assuming an investment risk, evidently requesting this Court to overturn the lengthy deliberations of the SEC before it issued Rule 151; however, even before Rule 151, SEC Release 6051[4] provided that a contract

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(Continued from previous page)

"These risks are of two types—mortality risks and investments risks. A significant assumption of both kinds of risks is required, in the Commission's view, for a contract to be exempt pursuant to Section 3(a)(8) from the full disclosure and prospectus delivery requirements of the Act." (p.191)

"A contract which does not place upon the issuing insurance company a meaningful mortality risk cannot be regarded as 'life insurance' or an 'annuity' for purposes of the federal securities laws. A contract which does not impose meaningful mortality risks upon an insurance company is offered and purchased merely for investment, and purchasers of such contracts are entitled to the same protections, rights and remedies provided by the Act as to the purchasers of any other security which is offered and sold as an investment." (p.191)

[4] "Certain guaranteed investment contracts promise that a relatively low rate of interest will be credited on accumulating funds but also provide for crediting of discretionary excess interest, and the contract is sold by placing primary emphasis on the possibility that high discretionary interest will be credited. *In economic reality the insurer issuing such a guaranteed investment contract is asking the potential purchaser to assume the risk* that, after the expiration of an initial guarantee period during which high discretionary interest will be credited, interest to be credited will fall to the much lower guaranteed rate. Advertisements sponsored by insurance companies or authorized salespersons (such as broker-dealers) which emphasize high current discretionary excess interest and relegate mention of traditional annuity features to fine print must be viewed as *intended by the sponsors to encourage investment in guaranteed investment contracts principally by those investors who desire to assume the investment risk discussed above because their investment objective is to maximize tax-deferred capital accumulation rather than to acquire conventional annuity plans.*" (pp. 193-94, emphasis added)

such as VALIC's "fixed annuity", with its optional interest at the discretion of the issuer, was a security.

The SEC has not filed an amicus brief in this cause, confirming that the opinion does not conflict with any of its rules or regulations, unlike when the SEC was the petitioner in both *United Benefit* and *VALIC I*, where the lower courts did not follow its rules and regulations.

3. The Opinion Will Not Have Immediate Or Widespread Consequences.

This case arises out of the fraud and misrepresentations of VALIC in connection with the 403(b) annuity investment contracts sold by them. The case is important to VALIC and to Ott. But that is where its importance ends.

That, of course, is not the story told by VALIC, which seeks to cloak itself in the protection of the whole insurance industry. VALIC's Petition (and the Amicus Briefs) are replete with phrases like "enormous concern," "widespread adverse consequences," "substantial portion . . . thrown into jeopardy," " 'vital' importance," "significant changes," and other treasures of epic hyperbole.

VALIC attempts to do this by obfuscation. Throughout its brief VALIC calls its product "a traditional fixed annuity." A traditional fixed annuity is not what VALIC sold. It sold a product tailored to meet the unique benefits offered by the Internal Revenue Code to school teachers, nurses and other employees of nonprofit organizations. Nowhere does VALIC list the companies that sell similar Tax Deferred Investment Programs.

It is significant that VALIC never discloses the number of companies that sell 403(b) plans, nor the percentage of the industry sales these represent. Instead, VALIC orates in terms of the "industry," or a "major segment" of the industry. But only the VALIC 403(b) plan is affected by the decision in this case. The figures thrown about by VALIC deal with the industry as a whole, hoping to impress the court with large numbers. VALIC does

not even tell us the percentage or dollar amount of its business that these plans make up.

At least five fixed annuity contracts have already been registered with the SEC as securities. (ALI-ABA Conference on Life Insurance Company Products, "SEC Rule 151; Implications for SEC Regulation of Fixed Annuity Contracts and Other Insurance Products," p. 126, C189, 11/86). Hartford Life Insurance Company, one of the largest annuity sellers, registered its fixed annuity during the time SEC Release 6051 was in effect, which was just prior to the adoption of Rule 151. (Insurance Products Under the Securities Laws, 1985. PLI # B-4-6726.) VALIC's statements of exceptional importance are merely conclusions without factual backing.

The Petition takes the position that registration of fixed annuities with the SEC "will have widespread adverse consequences for the insurance industry, state insurance commissions, the SEC and policyholders." (Pet. 11) VALIC's position is contrary to the position of the insurance industry that was in effect in 1986 as the American Council of Life Insurance's Chief Counsel, Gary E. Hughes (and Amicus brief author), stated in his article before the ALI-ABA Conference on Life Insurance Company Products concerning Rule 151 registration of fixed annuity products as follows:

> "2. Disclosure Issues: For the most part, the disclosure format can be substantially similar to that used for variable annuity contracts. Principal differences would include S-K requirements in the following areas:"
>
> • • •
>
> "e. Note—*None of these have proven terribly burdensome,* but they are unique to the fixed an-

> nuity registration as opposed to the variable annuity because of the difference in the form used." (C189 *supra*, emphasis added).

VALIC also contradicts its own Amicus when it states that ". . . the companies also might have to conform to the requirements of the Investment Company Act of 1940, . . ." (Pet. p. 12). Otto's complaint does not allege a violation of the Investment Company Act of 1940. In the same article (C189, *supra*) Chief Counsel Hughes states as follows concerning insurance companies which issue fixed annuities which must be registered with the SEC as securities as follows at p. 127:

> "Most companies will not face the issue unless their sales of this product far outstrip sales of other products, but, in any event, substantial argument [can be made] that no 1940 Act registrations should be required merely because of the addition of an MVA, for example, to an otherwise traditional annuity contract."

The inconsistency of VALIC in its Petition before this Court and its own Amicus' prior positions published in a non-adversarial setting is obvious.

On Page 26 of its Petition VALIC implies that new rules under the NASD will now be applied to salesmen of this type of product. In fact, VAMCO, and its employees (only identified in the Petition as "VALIC's subsidiary" p. 3) who sold the product at issue were all registered as NASD representatives since they sold the admitted security, the variable account, as a combination contract with the fixed account (fixed annuity).

VALIC's assertion that ". . . relief under the Securities Act would nullify the actuarial determinations and risk-pooling arrangements on which the annuity plan is based" (Pet., p. 13) is false. Its product is a debtor-creditor instrument during the accumulation phase to which this case is addressed and there is no actuarial determina-

tion to be made unless the participant chooses to become an annuitant at retirement.

VALIC has not shown any other company that has misrepresented its product to the public the way VALIC here has or which would be affected by this decision. VALIC's variable annuity is registered with the SEC and the fixed annuity in the case at bar is merely an option attached to the variable. The only problem that this decision has for VALIC is that it will be liable for violations of the Securities Exchange Act of 1934 (fraudulent misrepresentations and omissions). Significantly, the thrust of this litigation is not for rescission, but for the interest that VALIC represented it would pay but failed to pay.

4. The Opinion Is Interlocutory In Nature.

The decision below is but one part, albeit an important part, of the case against VALIC. Untouched by the reversal are pleading matters and causes of action for breach of contract, fraud, conspiracy and RICO. The only cause of action to which the opinion is final is Otto's ERISA claim. No damages have been assessed. This is not the "extraordinary" case that warrants granting the Writ prior to final decree. See *Hamilton-Brown Shoe Co. v. Wolf Brothers & Co.*, 240 U.S. 251, 257-58 (1915). See also Conclusion of this brief *infra.*

What VALIC is really seeking is an advisory opinion overruling the determinations of the SEC. This request should be declined. The arguments raised by VALIC in its petition were all raised by the insurance industry, its spokesmen and its members before the SEC and were rejected. The SEC has determined that the guarantee of a low rate of interest is, alone, not sufficient to shift investment risk to the insurer to insulate it from the Securities Acts (Release 6645 at p. 27; Release 6051 at p.193-4; Release 6558; *Otto,* 814 F.2d at 1142)

5. The Opinion Is Consistent With The McCarran-Ferguson Act And Other Regulatory Schemes.

The Petitioners argue, at pages 23-28 of their Brief, "The Court of Appeals' Decision is Inconsistent with the Congressional Scheme of Exclusive State Regulation of Insurance." Petitioners raise the McCarran-Ferguson Act, 15 U.S.C. Sec. 1011 *et seq.*, as a bar to application of the federal securities acts to VALIC's fixed annuity program. This argument has been repeatedly rejected by this Court, as stated in *S.E.C. v. National Securities, Inc.*, 393 U.S. 453, 461 (1969):

> "Less than two years ago the Court approved the application of the registration requirements of the Securities Act of 1933, Sec. 5, 48 Stat. 77, 15 U.S.C. Sec. 77e, to certain annuity contracts issued by insurance companies. *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967). The Court explicitly rejected arguments based on the McCarran-Ferguson Act in a similar case of slightly earlier vintage. *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 67-68 (1959). Although the securities laws contain a number of exemptions relating to insurance and insurance companies, the Commission has traditionally regulated a number of activities related to insurance securities. Of course, under the securities laws state regulation may co-exist with that offered under the federal securities laws. [citations] *But is has never been held that state regulation of insurance securities pre-empts federal regulation, on the theory that the federal securities laws would be 'superseding' state laws regulating the 'business of insurance.'*" (emphasis added; footnotes and some citations omitted).

In sum, the Petitioners entire argument that state regulations of insurance companies pre-empts finding the product sold by VALIC to be a security is not the law. There is no reason to accept the very same argument in this case that has been rejected by this Court many times in the past.

Likewise, Petitioners reliance on the cases of *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551 (1979), *Landreth Timber Co. v. Landreth,* 471 U.S. 681 (1985), *Marine Bank v. Weaver,* 455 U.S. 551 (1981), *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462 (1977), and *Piper v. Chris-Craft Industries, Inc.,* 430 U.S. 1 (1977) is misplaced. These cases were cited for the proposition that any alternative regulation should pre-empt application of the Securities Acts. *Daniel* dealt with a non-contributory pension plan (the participant did not invest his own funds) which was regulated extensively by ERISA, unlike the fixed annuity plan in the case at bar which the Court of Appeals has held is exempt from ERISA regulation (814 F.2d at 1135). *Santa Fe* dealt with whether a dispute involving corporate mismanagement under state corporation law could be brought under the Securities Act. The court held that the fundamental purpose of the Act as implementing "a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute" (430 U.S. at 478), unlike the case at bar where the complaint is for failure to make any disclosure under the Securities Act. *Landreth* involved the sale of 100% of the stock of a business which was required to be registered with the SEC. *Piper* involved an attempt to extend the coverage of the Securities Acts to an unsuccessful takeover bidder. *Marine Bank* involved the application of federal banking laws which protected the investor and the Court therefore held that protection under the federal securities acts were unnecessary much like *Daniel's* which had applicable federal regulatory law available.

In short, none of the cases relied upon by VALIC involve the sale of unregistered securities to investors where no fraud protection exists except the Securities Acts; they only stand for the general proposition that when better protection is afforded the investor under

other federal regulatory schemes, the Securities Acts will not be extended. Such is not the issue in the case at bar. The only question is whether the fixed annuity plan with its unlimited option is a security.

B. The Petition Should Be Denied Because The Opinion May Be Affirmed On Grounds Not Discussed In The Opinion.

1. The Fixed Annuity Was An Admitted Option On An Admitted Security, The Variable Annuity.

Plaintiff has pointed out that VALIC offered a participant an *option* to switch from fixed to variable and vice versa. This option is found in the Owner's Manual (R.52, Ex.B), the Prospectus (R.52, Ex.C) and the Sales Literature (R.174, Ex.I). By determining that the fixed accumulation account (fixed annuity prior to the selection of a true annuity on retirement) sold by VALIC is a security because it contains an option on the variable annuity which is a security, the court would not have had to reach the question of whether it qualified as an insurance product under SEC Release 6051, SEC Rule 151 or even the Supreme Court cases of *VALIC I* or *United Benefit.* This unanswered issue alone resolves the question of whether the fixed annuity plan containing an option on the variable annuity is a security.

VALIC did not answer this issue in its Appellate brief, and admitted in oral argument before the Court of Appeals that an option to purchase a security is itself a security (Oral Arg. Trans., p.16)[5]. Such an admission

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[5] Judge Cudahy: "How about this aspect of convertability into the variable account—you don't answer that in your brief, I don't believe. That can be described as an option to purchase a variable product can't it?"

Randall Mitchell: "Well, your Honor it is no different than the array of options that any participant would have as to how to use his funds. The variable annuity is a registered security. *An option to purchase an interest in a security, the variable an-*

(Continued on following page)

constitutes a judicial admission which no longer may be controverted in the appeal. Graham, *Handbook of Fed. Evid.* (1981), Sec. 801.26; *Glick v. White Motor Co.*, 458 F.2d 1287, 1291 (3rd Cir., 1972). For an application of such admission in oral argument, see *Peoria Union Stock Yards Co. v. Penn Mutual Life Ins.*, 698 F.2d 320, at 322 (7th Cir. 1983).

This option was by no means free to the participant. VALIC charged a 5% fee on the first $5,000 of contributions and a lesser percentage down to 3½% on additional contributions regardless of whether the funds went into the fixed account or the variable account (R.174). Since money market accounts and mutual funds can be invested in without charge, the cost could only have been for the unlimited option to switch back and forth without cost.

Section 3(a)(10) of the Securities Act of 1934 (15 U.S.C. Sec. 78C) defines a security in part as follows:

> "... option or privilege on any security, ..." and "any ... warrant or right to subscribe to or purchase any of the foregoing" i.e., "investment contract" or "any instrument commonly known as a security."

An option on a security is a security. *See Mansback v. Prescott, Ball & Turben,* 598 F.2d 1017, 1026, fn. 40 (6th Cir. 1979); *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 750-51 (1975); Loss, "Fundamentals of Securities Regulation" (1983) pp. 250-258 (1986 Supp.); Loss, "Securities Regulation" (1961 Ed.) pp. 467-469 (1969 Supp.).

(Continued from previous page)

nuity, is a security just as I suppose an option to purchase a share of stock generally could be characterized as such, but that doesn't answer the question of what the character is of the fixed annuity. * * *" (emphasis added)

Judge Cudahy: "Well I don't quite follow that, because if you have an option to switch tracks on an ongoing basis every time you put in money aren't you purchasing an option to switch tracks at some later date?"

Although not mentioned in the opinion, the existence of the option is independent grounds for holding that the VALIC "Tax Deferred Investment Plan" and fixed annuity plan is a security.

2. The Case Deals With The Accumulation Phase Of The Fixed Annuity Which Is An Investment Contract Or Promissory Obligation.

An additional ground for holding that VALIC's fixed annuity is a security not mentioned in the opinion is that the attributes of the annuity must be examined with emphasis on the "accumulation phase", when it was a debtor-creditor instrument. Although not discussed in the opinion, it is proper to break down the VALIC fixed annuity program into its accumulation phase (at issue in this case) and its true annuity phase (if one is purchased). *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 210-211 (1967).

The question is, what is the proper definition of an investor's fixed accumulation account. Although not discussed in the opinion, during its accumulation phase it really constitutes a promissory obligation, as stated by VALIC in its handbook (R.52, Ex.B) (see *supra* Statement of Case at pp. 3-4). Thus, the account has all the attributes of a promissory obligation or "note" (*Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 [7th Cir. 1984]) or "transferable share", "certificate of deposit", or "certificate of interest or participation in any profit-sharing agreement", all of which are specifically included within the definitions of a "security" in the federal securities laws (15 U.S.C. 78[c]). This is another issue which VALIC refused to answer in any of its appellate briefs. Under *United Benefit* analysis, the VALIC fixed annuity plan is a security.

C. The Court Of Appeals Was Correct In Holding The VALIC Fixed Annuity Plan A Security And Subject To The Federal Securities Laws.

1. The Fixed Annuity Plan Fails All Tests Of The SEC And The Case Law.

a. VALIC Fails All Tests Of Rule 151.

While VALIC has admitted that it fails the SEC's objective investment risk test of Rule 151 (see Point A-2b of this brief), in reality, VALIC's product did not meet *any* of the Rule 151 tests.

(1) The Marketing Test of Rule 151.

VALIC also fails the marketing test of Rule 151 [(a)(3)]. Its fixed accumulation account (fixed annuity) is directly compared to IRA's and mutual funds. In addition, VALIC fails both standards set forth in Release 6558.[6] VALIC advertised the fixed account as follows: "VALIC endeavors to provide its participants in the Fixed Account with the highest current interest available." Further, the fixed accumulation account was sold as part of a combination contract which included the unlimited option to freely transfer any or all of the fixed account into the variable account (an admitted security) and thus was sold as "one type of tax-sheltered investment that is interchangeable with other such investments," contrary to Release 6558. The salespeople (VAMCO) were NASD members—not insurance salesmen. VALIC fails all tests promulgated by the SEC requiring the product not be

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[6] "The Commission recognizes it is difficult to identify precisely the circumstances under which a contract is being marketed primarily as an investment, since all annuity contracts contain some investment features. In the Commission's view, among the factors relevant to this determination are whether the contract is promoted (1) with substantial emphasis on current discretionary excess interest, and the possibility of future interest, or other investment-oriented features of the contract, and (2) as one type of tax-sheltered investment that is interchangeable with other such investments."

marketed primarily as an investment. See *Grainger v. State Security Life Ins. Co.*, 547 F.2d 303 (5th Cir. 1977), cert. denied, 436 U.S. 932 (1978).

(2) VALIC's Product Is Not Regulated By The State Of Illinois As Required By Rule 151.

Another test of Rule 151 [(a)(1)] for a security is whether there is "adequate" state regulation dealing with the particular product at hand. See SEC Releases 6558 and 6645 at p.6. The fixed annuity offered and sold by VALIC in Illinois is not specifically regulated by statute or regulation. (See Ill. Rev. Stat. ch. 73, sec. 613 et seq.; 50 Ill. Admin. Code sec. [Insurance]) 1 et seq. [1986]. This, and other elements dealing with investor protection, is precisely the lack of "adequate" state regulation focused on by Justice Brennan in his concurring opinion in *SEC v. VALIC*, 359 U.S. 65, 77-78 (1959). Compare this void for fixed annuities with Illinois' *specific* regulation of variable annuities tied to separate accounts, found at Ill. Rev. Stat. ch. 73, sec. 857.51-62, and at 50 Ill. Admin. Code sec. [Insurance] 1451.10-100.

VALIC can point to nothing in the record to support its claim that in Illinois its fixed annuity is specifically regulated by statute or regulations. In oral argument, VALIC's counsel could not identify any *specific* regulations, except an inaccurate statement that VAMCO's brokers are registered in the states where they sell the annuity. (See oral argument transcript pp. 17-18.) VAMCO is not registered to do business in Illinois (see Appellant's Brief, p.23 and Reply Brief, p.2). Because Illinois, like many other states, does not specifically regulate VALIC's fixed annuity, the product is a security under the tests of Rule 151 and prior SEC releases. See SEC Release 6558 (Rule

151); SEC Release 6050 (responding to commentary on proposed Rule 154).

The important point is this: No matter what criterion is looked to, what VALIC sold is a security. The decision in this case does not necessarily turn on Rule 151 or Release 6051. It *can* turn on these, but it does not matter which criterion is used because the result will always be the same. What VALIC sold is a security under each and every test that can be applied.

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CONCLUSION

No decision of any court of appeal, the Supreme Court or the SEC is, or has been shown by VALIC to be, in conflict with the opinion in the case at bar and no exceptional importance has been demonstrated.

VALIC has admitted that the status of this matter is technically interlocutory in nature. It is not necessary to grant its Petition to prevent extraordinary inconvenience or embarrassment in the conduct of the cause nor is the case of peculiar gravity or general importance. Obviously there is no criminal trial involved, no important jurisdictional questions present nor is there any pending injunction.

The absence of any unusual factors, as noted above, when combined with the interlocutory nature of this matter as it presently stands, and realizing that the denial of certiorari is without prejudice to renewal of issues that may be presented if and when certiorari is finally sought

from a final judgment, all mandate that VALIC's Petition for A Writ Of Certiorari should be denied.

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APPENDIX

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

January 29, 1987

Before

Hon. WILLIAM J. BAUER, Chief Judge

Hon. RICHARD D. CUDAHY, Circuit Judge

Hon. KENNETH F. RIPPLE, Circuit Judge

BEVERLY J. OTTO, individually, and on behalf of all others similarly situated, et al.,	)	Appeals from the United States District Court for the Northern District of Illinois, Eastern Division
Plaintiffs-Appellants,	)	
Nos. 85-1816, 85-1919 and 85-2410 v.	)	
	)	No. 82 C 4762
VARIABLE ANNUITY LIFE INSURANCE COMPANY, et al.,	)	Marvin E. Aspen, *Judge.*
Defendants-Appellees.	)	

ORDER

This order is in response to both the motion to modify the opinion submitted by the defendant, Variable Annuity Life Insurance Company (VALIC), and the plaintiff Otto's petition for rehearing.

In its motion to modify the opinion, VALIC requests that we delete from our opinion the following sentence: "Under this method, VALIC in effect guaranteed the ex-

cess interest rate on every deposit for the life of the annuity contract." VALIC claims that this statement is incorrect because VALIC had the right to change the interest rates paid on past contributions. According to VALIC, this right "necessarily" was included in VALIC's discretion to determine the excess interest rates paid on current contributions. VALIC argues that deleting the sentence would not affect the soundness of the opinion.

In its response to VALIC's motion, Otto agrees with VALIC that the sentence in question is factually incorrect. Otto, however, argues that the correctness of the sentence is crucial to the opinion's determination that the fixed annuity is not a security but an insurance product. Otto requests, both in its response to VALIC's motion and in its petition for rehearing, that we withdraw our entire discussion of this issue and find instead that the fixed annuity is a security.

We decline at this time to modify the opinion as requested by either party. It is far from obvious to us that VALIC's right to set the excess interest rate "necessarily" included the right to alter the interest "bands" paid on past contributions. In an affidavit submitted to the district court by VALIC, Larry E. Barnett, the Regional Manager for VALIC's Midwest Region and Vice-President of VAMCO, described the method by which interest was awarded under the fixed annuity, Defendants' Memorandum in Opposition to Plaintiff's Motion for Class Certification, Exhibit C. He stated, as is clear, that "[e]xcess interest over the guarantee may be paid in the sole discretion of the Company's Board of Directors." *Id.* He explained, however, that these discretionary changes in the excess interest rate affected only current, and not past,

contributions: "[I]nterest on the fixed annuity is calculated by the 'new money' method, meaning that changes, up or down, in excess interest rates affect only monies contributed during the current period. This practice . . . is sometimes referred to as 'banding' . . . ." *Id.*

Attached to the affidavit was a question and answer which, according to Mr. Barnett, was included in a formal written proposal sent to "virtually all, if not all, prospective customers" in the Midwest Region during the years 1979 to 1983. *Id.* That question and answer read as follows:

> Describe the basis for the dividends or current interest rate illustrated above.
>
> The current rate of interest is composed of the guaranteed interest rate plus "excess interest." Excess interest is declared and guaranteed for deposits received in the Fixed Account on a calendar quarter basis by the Board of Directors of VALIC. Excess interest is computed daily and credited on amounts remaining in a participant's Fixed Account at the end of each calendar quarter.
>
> VALIC employs the new money method for crediting excess interest. The current interest rate is paid on monies for the period in which it is in effect. *Should the current interest rate change (i.e., up or down), it would not affect a participant's past contributions but only those contributions deposited while the new rate is in effect.* A change in the current rate would in no way affect the past accumulations in a participant's account balance.

Id. (emphasis added).

There is no indication in either the affidavit or the question and answer submitted with the affidavit that VALIC had the authority to change the interest rates banded to past contributions. Indeed, VALIC's repeated

assertions that its discretion to determine the excess interest rate in no way affected the interest paid on past contributions suggests that VALIC did not have the authority to alter the "bands" of interest rates. At the very least, these statements were likely to mislead prospective customers, and this court, into believing that the bands were guaranteed.

On appeal before this court, VALIC did nothing to correct this possibly incorrect impression it had created before its potential customers and the district court. In its brief, VALIC described the fixed annuity as follows:

> Like virtually all of its competitors at that time, VALIC employed the "new money" or "banding" method for crediting excess interest to the fixed annuity account; *i.e.*, the excess interest rate set by the Board of Directors was paid on deposits made during that particular period. Subsequent fluctuations in the excess rate did not affect a participant's past contributions. Each deposit stayed in its "band," and continued to draw interest at the rate in effect when the deposit was made.

Defendants' Brief at 4-5 (footnote omitted). Again, in this description of the fixed annuity, VALIC stressed that its changes in the excess interest rate did not affect past contributions, which would remain in their bands.

In a footnote to this discussion, VALIC does indicate that it "modified its interest-crediting practice" subsequent to the end of Otto's participation in the fixed annuity plan. *Id.* at 4 n.4. This footnote refers to a letter included in the appendix to Otto's brief. The letter, however, deals primarily with VALIC's decision to guarantee the excess interest rate paid on new deposits for one year,

a decision unrelated to the interest rates for past contributions.[1] The letter also lists the interest rates applicable to past contributions. As Otto points out in her petition for rehearing, this list "reduced the prior banded interest rates from 1982 which were as high as 14.5% down to 13%." Plaintiff's Petition for Rehearing at 12. Yet this fact, that VALIC was for the first time attempting unilaterally to reduce a banded interest rate, is not disclosed in the letter and can be deduced only with the possession of independent knowledge of what the bands were prior to the letter.

If VALIC did, in fact, have the right to reduce the banded interest rates, our determination that the fixed annuity was an exempt insurance product not subject to the federal securities laws may be flawed. Whether VALIC possessed this discretion certainly is important to the level of investment risk assumed by VALIC. In addition, our opinion relied in part on the fixed annuity's satisfaction of all of Rule 151's "safe harbor" requirements. One of those requirements apparently would not be met if VALIC had the authority to change the interest bands. The failure of the fixed annuity to qualify for safe harbor treatment under Rule 151 would not require us to find that the fixed annuity was a security, both because the Rule technically does not cover annuities for the time period in question and because the rule does not purport to provide

---

[1] The letter incorrectly states that the excess interest rate is paid on past as well as new deposits: "As in the past, excess interest is determined at the discretion of VALIC's Board of Directors and is computed on the basis of amounts remaining on deposit in your fixed account at the end of each calendar quarter."

an all-inclusive definition of all annuities that are exempt from the federal securities laws. Nevertheless, the failure of the fixed annuity to satisfy any prong of Rule 151 clearly is relevant to and requires a reevaluation of the status of the annuity.

Before deciding finally whether or not to modify our opinion, we feel it is appropriate to allow the parties to submit further briefs on this issue. The briefs should be directed at explaining more fully both the extent of VALIC's authority to alter the interest rates, including those paid on past contributions, and whether, in light of that authority, the fixed annuity is properly viewed as a security or insurance. We also direct VALIC to explain to this court why, when describing its banding method of computing interest, it did not inform the court that VALIC claimed to have the discretion to alter the bands assigned to past contributions. This failure seems to us to be clearly misleading. Because VALIC's omission apparently involves a fact central to the analysis of a close question, VALIC's failure to disclose and subsequent motion to modify force this court to waste valuable judicial resources and may call for sanctions as well as possibly affecting the result.

VALIC, therefore, is directed to file a brief not more than 20 pages in length by February 13, 1987. Otto may file an answering brief not more than 20 pages in length by March 2, 1987.

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In the Supreme Court of the United States

OCTOBER TERM, 1987

THE VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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REPLY BRIEF FOR THE PETITIONERS

In our petition, we showed that the court of appeals' decision—which is the first ever holding a fixed annuity product to be subject to the federal securities laws—is both erroneous and of substantial public importance. The significance of the decision below is clearly demonstrated by the five *amicus curiae* briefs that the insurance industry, state insurance commissioners, and state guaranty associations have filed in this Court urging that review be granted. These expressions of concern attest to the unprecedented nature of the court of appeals' ruling and the serious disruption it portends for the insurance business and the system of state insurance regulation.

Respondent's brief in opposition offers no credible reason why this Court's review is not warranted. Respondent largely abandons the court of appeals' reasoning and advances no tenable standard of her own for distinguishing "insurance" from "securities." Rather, she devotes the bulk of her brief to alternative grounds for the decision below that by her own admission the court of appeals did not adopt and that in fact it rejected. Moreover, apart from her repeated *ipse dixit*, respondent utterly fails to refute the showing in the petition and the *amicus* briefs of the public importance of this case.

I.

Nowhere in her brief in opposition does respondent defend the rationale of the court of appeals' decision or answer our argument that the decision rests on a serious misconception of SEC Rule 151. Respondent merely reiterates the Seventh Circuit's misunderstanding of the Rule (Br. in Opp. 11, 12):

> [T]he SEC has determined that unless a contract guarantees the excess rate of interest for a minimum of one year the purchaser/investor has the investment risk.

* * * * *

> Section (b)(3) of Rule 151 is an objective test, as determined by the SEC, as to when the investment risk shifts from the participant to the insurer, that being when the insurer guarantees that the excess interest rate will remain in effect for at least one year.

Rule 151 provides no such test. Rather, as the SEC explained in promulgating the Rule, it establishes a standard for determining those annuities that are "*clearly*" excluded from the federal securities laws and thus are given the Commission's "*assurance* that [they are] covered by the section 3(a)(8) exclusion." 51 Fed. Reg. 20,254, 20,255 (1986) (emphasis added). Contrary to respondent's characterization, Rule 151 creates a safe harbor, not a comprehensive definition of exempt annuities, and the failure to meet the stringent test for safe-harbor treatment in no way suggests that an annuity therefore becomes a security. See Pet. 20-22.[1]

Compounding her misinterpretation of Rule 151, respondent also misconstrues the applicable legal standard under this Court's decisions for determining whether an annuity product is subject to the securities laws. In her view, an annuity, to be excluded, must "impose[] no investment risk" on the purchaser (Br. in Opp. 6).

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[1] Respondent charges (Br. in Opp. 1, 7) that VALIC misrepresented its policy to the courts below. While it is not material to the question presented in this Court, we must note that respondent's accusation is entirely without merit, as outlined in the petition (at 7-8 n.3) and more fully explained in VALIC's submissions to the court of appeals. See, *e.g.*, VALIC's C.A. Br. 18 ("[a]lthough VALIC is not required by the contract to refrain from modifying excess interest for one year, in practice VALIC preserved (or improved) the interest bands during the entire class period"); Tr. of Oral Arg. 15 (statement of VALIC's counsel) ("[t]he product at issue in this case at the time it was involved in the class case did not comply with that one requirement under proposed rule 151"); *id.* at 7 (Judge Cudahy: "They * * * do not qualify under the proposed rule that interest can only be recalculated every year and they have recalculated every 3 months, as I understand it." Counsel for respondent: "That is right").

As the Court stated in *VALIC I*, however, a policy is an excluded annuity and not a covered security if it provides "*some guarantee* of fixed income" and "involves *some investment risk-taking* on the part of the company. * * * '[I]nsurance' involves a guarantee that *at least some fraction* of the benefits will be payable in fixed amounts" (359 U.S. at 71) (emphasis added). In fact, the SEC has specifically recognized that *VALIC I* and *United Benefit* "do not require the insurer to assume *all* investment risk for a contract to be insurance under section 3(a)(8)." 49 Fed. Reg. 46,750, 46,752 (1984) (emphasis in original). And even the safe harbor of Rule 151 does not require that the insured bear *no* investment risk.[2]

Under *VALIC I* and *United Benefit*, VALIC's excess interest fixed annuity was not a security, as the court of appeals correctly concluded in its initial decision. VALIC guaranteed payment of both principal (including accrued interest) and a specified rate of interest. Thus, its policy had the essential features of a traditional fixed annuity, and VALIC assumed a substantial—indeed, the predominant—investment risk under the policy. As illustrated by the recent stock market drop, these guarantees afford substantial protections for policyholders who wish, as with all insurance products, to have the peace of mind that their retirement funds are secure and are being managed in a conservative manner.[3]

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[2] Respondent relies (Br. in Opp. 15) on the fact that the SEC, although not a party (compare *VALIC I* and *United Benefit*), has not sought to file a brief as *amicus curiae* in this Court. Of course, it is the customary practice of the federal government not to participate as an *amicus* at the petition stage. However, in light of respondent's emphasis on the absence of the SEC, her substantial misinterpretation of SEC Rule 151, and the obvious importance of this case to the SEC, the Court may wish to invite the Solicitor General to submit a brief expressing the views of the United States.

[3] Because VALIC guaranteed full payment of all credited principal and interest (including accrued excess interest) and also

Respondent contends, however, that VALIC's guaranteed rate of 4% interest (3½% after the first 10 years) on past and future deposits—which was comparable to that guaranteed by other insurers on similar fixed annuities at the time—was below the rate of return on various investments and was too low to constitute a meaningful investment risk (Br. in Opp. 5-6, 9, 14, 18). The court of appeals expressly found to the contrary, concluding that the guaranteed rate was sufficient to place a substantial investment risk on VALIC (Pet. App. 8a-9a). Moreover, even for purposes of the safe harbor, the guaranteed rate of interest need only be equal to that set in the nonforfeiture provision of the insurance law (see Rule 151(b)(2)(ii) and (c)), which during the relevant period was 3% (see Pet. App. 12a & n.3). And more fundamentally, as explained in the petition (at 18 n.8), it is an integral feature of this long-term insurance product that the guaranteed rate of interest be below prevailing shorter-term market rates of return (which do not include protection of principal and minimum interest payments on future deposits) in order to ensure that the guarantee can be safely and reliably maintained over the life of the annuity. That the excess interest provision may have been a significant part of the economic inducement for customers to purchase this policy, as respondent emphasizes, does not negate the fact that the fundamental characteristic of VALIC's fixed annuity was the guarantee of principal and interest and that this guarantee placed a substantial investment risk on VALIC.

The cases cited by respondent (Br. in Opp. 8-10) do not support the court of appeals' decision. Indeed, the court itself did not rely on those cases; on the contrary, despite respondent's citation to them below, the court

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guaranteed to pay 3½-4% interest on all future deposits, respondent is incorrect in asserting (Br. in Opp. 13) that "if any investment risk to VALIC looked likely to occur all VALIC needed to do to eliminate its risk was lower the interest it paid on past 'bands.'"

in its original decision held that VALIC's fixed annuity was *not* a security.[4]

Respondent also fails to distinguish the decisions of this Court, such as *Marine Bank* and *Daniel*, that have looked to the existence of alternative regulatory systems in determining whether a particular instrument is a security (see Pet. 15, 23-24, 28). Respondent is simply wrong in contending that "no fraud protection exists [here] except the Securities Acts" (Br. in Opp. 20); state insurance codes, as well as state fraud law generally, prohibit false and deceptive practices by insurance companies (see Pet. 25; see also Nat. Ass'n of Ins. Comm'rs Am. Br. 7). Moreover, the fact that this protection is afforded under state law is not a controlling distinction, as respondent suggests (Br. in Opp. 20-21),

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[4] In *Peoria Union Stock Yards Co.* v. *Penn Mut. Life Ins. Co.*, 698 F.2d 320 (7th Cir. 1983), the "group deposit administration annuity contract" contained, in contrast to VALIC's fixed annuity, no guarantee of interest after the first three years (*id.* at 322, 325); instead, it provided that all net interest earned was required to be credited to the account (*id.* at 322, 325), so that "the income available to fund th[e] obligations fluctuated with the investment experience of Penn Mutual. * * * It was as if the pension trustees had bought shares in a mutual fund" (*id.* at 325). In *Grainger* v. *State Sec. Life Ins. Co.*, 547 F.2d 303 (5th Cir.), rehearing en banc granted, 553 F.2d 1008, rehearing en banc vacated and opinion on rehearing, 563 F.2d 215 (1977), cert. denied, 436 U.S. 932 (1978), the court of appeals held that a "variable investment plan"—which, again in contrast to VALIC's fixed annuity, contained no guaranteed rate of interest and required that 90% of the profits earned be allocated to the benefit of policyholders (547 F.2d at 304-305)—was not an annuity as a matter of law and could be a security only if it was promoted as an investment rather than insurance and if the policyholders' payments were disproportionately high in relation to the death benefits offered (*id.* at 306-307, 563 F.2d at 216).

Instead of *Peoria Union* and *Grainger*, the closest analogy to the present case is *Olpin*, a decision that is plainly at odds with the approach of the court below (see Pet. 20). The fact that *Olpin* involved a whole life insurance policy issued by a mutual insurance company is a formal difference that does not, as respondent asserts (Br. in Opp. 8), distinguish the essential features of that case from this one.

because Congress determined in the McCarran-Ferguson Act that there should be state rather than federal regulation of the business of insurance.

Respondent's interpretation of the McCarran-Ferguson Act is also unfounded. That Act, together with the explicit exemption in the securities laws for insurance and annuities, strongly counsels against extending the federal securities statutes to fixed annuities, an insurance product traditionally regulated by the states. In *SEC* v. *National Securities, Inc.*, 393 U.S. 453 (1969), upon which respondent relies (Br. in Opp. 19), the Court simply held that an insurance company's acquisition of the stock of another insurer in connection with a merger does not involve the "business of insurance" within the meaning of the McCarran-Ferguson Act. See 393 U.S. at 457-461; see also *Group Life & Health Ins. Co.* v. *Royal Drug Co.*, 440 U.S. 205, 230-231 n.38 (1979). That holding has no application here, since the issuance of excess interest fixed annuities clearly constitutes the business of insurance and has traditionally been subject to exclusive state regulation.

The *amicus* brief of the National Association of Insurance Commissioners, which is submitted on behalf of the insurance regulatory officials of all 50 states and the District of Columbia, is a compelling indication of the conflict between the decision below and the McCarran-Ferguson Act policy of exclusive state insurance regulation. As that brief demonstrates (at 4, 7), "[t]he court of appeals' opinion impacts the traditional state regulatory approach to the sale of fixed annuities," under which excess interest fixed annuities have been "exclusively governed by the state insurance laws and regulations." Respondent's position simply reads the Act out of the case.

II.

Unable to defend the reasoning of the court of appeals, respondent argues that its decision is not of sufficient importance to warrant further review. She asserts

(Br. in Opp. 1, 15) that the decision below pertains only to VALIC's excess interest fixed annuity and will not affect other policies or companies. That contention is belied by the numerous *amicus* submissions, which demonstrate the widespread consequences of the decision below.[5] As these briefs show, many companies have issued a large number of excess interest fixed annuities like VALIC's, as well as other insurance products that operate analogously to excess interest policies (such as participating life insurance contracts). Thus, "[t]he precedent established in the court of appeals' decision could place an extensive portion of the annuities currently subject to state regulatory oversight under the control of federal securities laws" (Nat. Ass'n of Ins. Comm'rs Am. Br. 7).

Respondent also states (Br. in Opp. 16) that five companies had registered their fixed annuities with the SEC as securities prior to the court of appeals' decision. Even if those contracts were fixed annuities comparable to VALIC's, the fact that five companies, out of hundreds or thousands in the field, chose to file registration statements for a relatively small number of policies is hardly meaningful. In fact, however, all of these registered policies (including that of the Hartford Life Insurance Company) did not resemble VALIC's fixed annuity because they contained a so-called market value adjustment feature that could result in the invasion of the policyholder's principal. See 51 Fed. Reg. at 20,257 n.19; PLI, *Insurance Products under the Securities Laws* 15, 73, 77-78 (Corporate Law and Practice Handbook No. 493, B4-6726, 1985). This adjustment feature is a means of shifting a significant investment risk from the insurer to the insured by reducing the amount payable upon withdrawal. Such a contract, unlike an excess interest fixed annuity, is entirely ineligible for the safe harbor

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[5] See Amer. Coun. of Life Ins. Am. Br. 2; Nat. Ass'n of Life Cos. Am. Mot. ii & Br. 3; Nat. Ass'n of Ins. Comm'rs Am. Br. 7; Ass'n of Calif. Life Ins. Cos. Am. Mot. iii & Br. 4.

of Rule 151 (51 Fed. Reg. at 20,256-20,257 & nn. 14-19; 49 Fed. Reg. at 46,752 & n.17).[6]

Finally, noting that the employees of VALIC's subsidiary (VAMCO) who sell its annuity policies are already registered as NASD representatives, respondent argues (Br. in Opp. 2, 17, 24) that it would not be a significant burden for insurance agents to register under federal "broker-dealer" requirements as a result of the court of appeals' decision. VALIC's agents are so registered (as well as also being registered as insurance agents pursuant to state law) because a portion of their business consists of variable annuities that *VALIC I* held to be securities. But as the *amicus* briefs indicate, registration of insurance agents as NASD representatives is not the common practice in the insurance industry. Contrary to respondent's contention, this registration requirement—as well as the numerous other requirements of federal law that would become applicable (see Pet. 9, 12-14, 27-28)—shows the disruptive effect of the court of appeals' decision.

III.

Having failed either to justify the Seventh Circuit's analysis or to minimize the significance of its decision, respondent seeks to avoid further review by advancing a miscellany of alternative grounds for affirmance of the judgment.[7] These arguments, even if meritorious, would not provide a reasonable basis for leaving in place a de-

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[6] Respondent further relies (Br. in Opp. 16-17) on a statement of an insurance association lawyer at an ALI-ABA conference that registration of these annuities had not been "terribly burdensome" and would not pose a problem under the Investment Company Act for "[m]ost companies." However, given the small number of companies and contracts involved, those observations do not shed any light on the consequences of holding standard excess interest fixed annuities to be securities.

[7] Respondent concedes that her arguments, although presented below, were not adopted by the court of appeals. In fact, the court rejected these arguments in its first opinion, which held that VALIC's fixed annuity was not a security. Nothing in the court's subsequent reconsideration revived these previously rejected claims.

cision that is both erroneous and of substantial public importance. But the arguments are in fact unavailing.

Respondent first argues (Br. in Opp. 4, 6, 18, 21-22, 24) that VALIC's fixed annuity constituted an option on a security because it was part of a combination contract that permitted the purchase of a variable annuity (which, under *VALIC I*, was a security). However, the combination contract did not involve an option at all. It was simply a procedure for transferring funds between the fixed and variable plans at the current market price, not a right to purchase a variable annuity at a predetermined preferential price; it therefore did not represent a significant right under the contract, since the general public equally could buy a variable annuity at the market price. Beyond that, even if the combination contract could be said to contain an option, that does not mean that the option was included in the fixed annuity, which is what is at issue in this case. See Pet. App. 3a (plaintiff class certified as all Illinois participants "in VALIC's fixed annuity plan" between 1975-1982).

Respondent also asserts (Br. in Opp. 3, 17, 23) that the fixed annuity should be divided into an "accumulation phase" and a "pay-out phase" and that this case involves only the accumulation phase. However, unlike the unusual circumstances presented in *United Benefit* (387 U.S. at 207-210), there is no basis here for separating an integrated policy into two divisible parts. When a fixed annuity policyholder entered into the contract with VALIC and began to make payments (the so-called accumulation phase), he was guaranteed minimum annuity purchase rates based on mortality assumptions then in effect, which assured him the right to purchase an annuity at any time thereafter at those rates (the so-called pay-out phase); in contrast, if the policyholder withdrew his money upon retirement and purchased an annuity from another company, it would be based upon the then-current annuity rates, which could be less favorable than the minimum rates in VALIC's contract. Moreover, again unlike *United Benefit*, during the accumulation

phase VALIC guaranteed principal and specified interest, and it included the premiums in its general account and invested them in long-term debt-type instruments pursuant to state insurance law.

Respondent next contends (Br. in Opp. 12, 24) that VALIC's fixed annuity was a security because it did not meet any of the elements of SEC Rule 151. However, notwithstanding respondent's claim (*id.* at 5 & n.1, 24) that the policy was marketed as an investment and not as an insurance product, both the court of appeals and the district court concluded that VALIC promoted its fixed annuity plan as insurance (Pet. App. 8a-9a, 13a, 40a-41a); respondent has presented no reason for this Court to reconsider, let alone to overturn, the concurrent determination of the courts below. Furthermore, contrary to respondent's unsupported and highly implausible assertions (Br. in Opp. 2, 25), VALIC's fixed annuity business, including its sales agents, was in fact regulated by the Illinois insurance commissioner. Thus, apart from the "one-year excess interest" guarantee that was the basis for the court of appeals' decision on rehearing, "VALIC's fixed annuity satisfies all of the requirements of Rule 151" (Pet. App. 12a).

Finally, respondent asserts (Br. in Opp. 13-15) that VALIC's fixed annuity did not meet the standards of SEC Release 6051, which was in effect prior to the adoption of Rule 151, because the policy involved no mortality risk for VALIC. As explained above, however, VALIC's fixed annuity guaranteed that the annuity purchase rates in existence when the contract was initiated would be available upon annuitization at any time in the future; because the purchase rates were based on then-current life expectancies, this guarantee imposed on VALIC the mortality risk that the policyholder would in fact live longer than his predicted life span as of the point the rates were computed. The SEC has recognized that guaranteed annuity purchase rates entail a mortality risk. See SEC Release 6051, 44 Fed. Reg. 21,626, 21,627-21-628 (1979).

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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No. 87-600

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Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SUPPLEMENTAL BRIEF OF RESPONDENTS IN RESPONSE TO BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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SUPPLEMENTAL BRIEF OF RESPONDENTS IN RESPONSE TO BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Brief for the Solicitor General as Amicus Curiae filed pursuant to the Court's invitation.

STATEMENT

The Solicitor General ("SG") raises two reasons why it supports this Court's granting the petition for certiorari: (1) the SG "believes the court of appeals' legal analysis is wrong" (SG Brief at p. 5) and its reasoning "unclear" (SG Brief at p. 6); and, (2) "This case has caused great interest and concern in the insurance industry. . . . The Court's opinion could . . . provide valuable

guidance to the lower courts and the industry as to the proper standards by which to judge these products." (SG Brief at p. 5). The Solicitor General's stated reasons for granting certiorari are not only inadequate, but more importantly, they are inaccurate on the facts of this case and the governing law.

There is no relationship between the product the Solicitor General describes in its Brief and on which it bases its analysis, and the "Tax Deferred Investment Program" marketed and sold by The Variable Annuity Marketing Company ("VAMCO"), a wholly-owned marketing subsidiary of The Variable Annuity Life Insurance Company ("VALIC"). The Solicitor General describes a stand-alone annuity which is not present here. The "Tax Deferred Investment Program" here had the following distinguishing relevant elements, none of which were fully discussed or analyzed by the Solicitor General, thereby rendering its conclusions fallacious.

1. The program is entitled "Tax Deferred Investment Program."

2. The "Tax Deferred Investment Program" provides that an investor could invest his money in the "fixed" accumulation account or in the variable accumulation account, or in a combination of the two. Further, the investor, at his option, could switch from fixed to variable and back again at any time without penalty. Thus, one of the things purchased by an investor was the option of investing (as admitted by VALIC in oral argument before the Court of Appeals) in a security, namely, the variable annuity (*see SEC v. VALIC,* 359 U.S. 65 (1959) (*"VALIC I"*)).

3. The "Tax Deferred Investment Program" was sold, not by VALIC itself, but by VAMCO. VAMCO's employees are not insurance agents, but licensed members of the National Association of Securities Dealers ("NASD"), which they must be to sell the con-

tract that contains the variable annuity held to be a security in *VALIC I*. VAMCO is not subject to regulation by the Illinois insurance department; nor was it otherwise subject to Illinois laws since it never qualified to do business within the state. In addition, the fixed accumulation account portion of the "Tax Deferred Investment Program" sold by VAMCO and issued by VALIC was not the subject of any regulation by the State of Illinois, where this class is certified.

4. VALIC only guaranteed a nominal interest rate of 4%. VAMCO, in marketing the product, emphasized VALIC's investment expertise which enabled it to pay interest ("the highest current rate") far greater than that guaranteed. The excess interest was at the total discretion of VALIC, and could be terminated or reduced at any time. VALIC misled Otto and the lower courts by failing to disclose that the excess interest rates were banded, and that VALIC could change the rates on past bands at any time to shift any investment risk from itself to the purchaser.

5. VALIC's guarantee of 4% (dropping to 3½%) on funds invested came at a time when market rates were as high as 14½%. At such a time, the investment risk on VALIC was therefore only for the guaranteed 4%, while the investment risk on the investor was for the wholly discretionary 10½%. At no time pertinent to this case was the percentage risk to VALIC higher than the percentage risk to the investor in the so-called "fixed" account.

VALIC's "Tax Deferred Investment Program" is a far cry from what the Solicitor General calls a "fixed annuity with a discretionary-interest component." SG Brief at p. 5. The Solicitor General's inaccurate characterization as to the nature of the product involved here distorts its subsequent analysis (as well as its Question Presented), and renders its advice to the Court suspect.

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DISCUSSION

I. The Court of Appeals' Decision Conforms With The Decisions of This Court, and Does Not Conflict With the Decision of Any Other Court of Appeals or With the SEC's Own Published Standards.

Significant by its absence from the Solicitor General's list of reasons for granting certiorari is any claim that the Court of Appeals' decision conflicts with any decision of this Court, including *VALIC I* and *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967) (*"United Benefit"*), nor any decision of the other court of appeal. There is good reason for this. *No new law was established by the Court of Appeals here in its final decision.* This factor mitigates heavily in favor of denying certiorari.

Neither can the Solicitor General point to any portion of any SEC Release or Rule with which the Court of Appeals' decision conflicts. Instead, the Solicitor General only takes issue with the clarity of the Court of Appeals decision, not the result. The Solicitor General does not say that the end result obtained here was erroneous. *See* SG Brief at p. 10.

It is the Solicitor General's reasoning which lacks clarity and consistency with the SEC's past pronouncements in this area. In its analysis of the status of VALIC's "Tax Deferred Investment Program" outside the safe harbor of Rule 151, the Solicitor General surprisingly states: "The lack of a meaningful mortality risk is not necessarily a disqualifying feature." SG Brief at p. 10. The Solicitor General's position is totally inconsistent with the long history of exemption of traditional insurance products under Section 3(a)(8) based in large part on that very factor. In adopting the objective test of Rule 151 as a safe harbor under Section 3(a)(8), the SEC traded off mortality risk for a one-year guarantee of

excess interest rates. Outside of the safe harbor, security status is still determined in reference to the "total facts and circumstances" test, in force under Release 6051. More importantly, and wholly ignored by the Solicitor General in its quest for an advisory opinion unrelated to the facts of the case, the governing law during the time period of the facts of this case was SEC Release 6051, under which, in the words of the SEC:

> "These risks are of two kinds—mortality risks and investment risks. A significant assumption of both kinds of risks is required, in the Commission's view, for a contract to be exempt pursuant to Section 3(a)(8) from the full disclosure and prospectus delivery requirements of the Act.
>
> * * *
>
> A contract which does not place upon the issuing insurance company a meaningful mortality risk cannot be regarded as 'life insurance' or an 'annuity' for purposes of the federal securities laws."

Respondent is at a loss to explain this oversight on the part of the Solicitor General. Release 6051 is nowhere mentioned in the Solicitor General's Brief. Is the federal government now ready to abandon the regulation of securities sold under the name of "annuities" so long as they are sold by insurance companies?

On the key issue of investment risk as a factor in determining security status, the Solicitor General states:

> "At least where, as here, a state-regulated insurer assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the investment-risk criterion is satisfied." SG Brief at pp. 8-9.

The Solicitor General's conclusion is directly contradicted by SEC Release 6051 as follows:

> "Certain guaranteed investment contracts promise a relatively low rate of interest will be credited on accumulating funds but also provide for crediting of discretionary excess interest, and the contract is sold by placing emphasis on the possibility that high discretionary interest will be credited. *In economic reality the insurer issuing such a guaranteed investment contract is asking the potential purchaser to assume the risk that, after the expiration of an initial guarantee period during which high discretionary interest will be credited, interest to be credited will fall to the much lower guaranteed rate.* Advertisements sponsored by insurance companies or authorized salespersons (such as broker-dealers) which emphasize high current discretionary excess interest and relegate mention of traditional annuity features to fine print must be viewed as intended by the sponsors to encourage investment in guaranteed investment contracts principally by those investors who desire to assume the investment risk discussed above because their investment objective is to maximize tax-deferred capital accumulation rather than to acquire conventional annuity plans." (Emphasis added.)

The Solicitor General has misapplied the concept of "investment risk" in its Brief to this Court. Investment risk, as Rule 151 and Release 6051 make clear, is the risk that the excess interest will be paid in the future after investment, not whether the principal and credited interest will be collected by the participant. The latter is a solvency argument, but the solvency of the issuer to pay principal and credited interest is irrelevant to the investment risk the investor assumes.

The stance of the Solicitor General that state regulation is sufficient protection for investors is in marked contrast to the SEC's position in Release 6050, where it stated:

> "The existence of state authorities who have certain regulatory powers and responsibilities for their respective states does not relieve the Commission of its duty and responsibility to administer the full disclosure and prospectus delivery requirements of the Act where the contract being sold is not exempt pursuant to Section 3(a)(8)."

The Solicitor General's reliance on state regulation of insurance companies for protection of investors and its claim that the "purpose of the securities laws is to ensure that investors in securities are fully and accurately informed about the issuer and the investment's relevant features, including its risks," SG Brief at p. 7, is contrary to this Court's prior holdings. State regulation of the insurance industry is designed to protect against insolvency of the insurance companies. The federal securities laws are designed to provide the investor with full disclosure to allow her to make an informed choice as to her investment decisions, and to provide the investor with effective remedies for fraudulent representations concerning such investments. *See* VALIC I, 359 U.S. at 77-78 (Brennan, J., concurring). It is the picture that the Solicitor General paints that is in conflict with the decisions of this Court and the SEC's own past declarations in this area, and not the Court of Appeals decision.

II. The Solicitor General Seeks An Advisory Opinion On Fixed Annuities.

The Solicitor General states that many different types of annuity products are now being sold by the industry and that an opinion in this case will "not necessarily resolve the application of the securities laws to all so-called fixed annuities." SG Brief at p. 5. It nevertheless says that an opinion could provide "valuable guidance to the lower courts and the industry as to the proper standards by

which to judge these products." *Id.* Other issues the Solicitor General would like an advisory opinion on, but which have never been raised in this case and which are totally irrelevant, are whether, if this product is a security, VALIC "is subject to the registration provisions of the Securities Act," whether VALIC "and its agents must comply with the broker-dealer provisions of the Securities Exchange Act" (a non-issue since they already comply), and whether VALIC "may lose its 'insurance company' exemption under the Investment Company Act of 1940." SG Brief at pp. 5-6.

Advisory opinions on securities issues, in the form of Rules and Releases, are, and should be, the responsibility of the SEC pursuant to its rule-making authority, and the Solicitor General should not be allowed to abdicate the SEC's role by shifting the responsibility to the Court, especially under the unique and limited circumstances of this case. The position of the Solicitor General is particularly surprising since it claims that the record may be inadequate for a review in at least two areas. SG Brief at pp. 9-10. These two areas are marketing (whether the contract was sold as a security) and meaningful mortality risk (whether VALIC was subject to such).[1] In spite of this, the Solicitor General suggests the Court grant certiorari so that guidance can be given. In short, an advisory opinion is being requested.

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[1] The SG is inaccurate regarding the incompleteness of the record on these two points. The record contains sales literature of the defendants, together with acknowledgments, reports, letters, etc. that show that VALIC through VAMCO went to great lengths to sell an *investment* to its customers, not an annuity. As to the mortality risk, VALIC assumed none. This can be seen from a reading of the contract itself. In short, the record is sufficient on both of these issues for purposes of this Court review.

III. The Court of Appeals Correctly Held VALIC's "Tax Deferred Investment Program" To Be A Security Under Section 3(a)(8).

The Solicitor General states, in its Brief at p. 6, "The reasoning of the Court of Appeals is unclear." The Solicitor General's Brief gives the impression that the Court of Appeals relied entirely on VALIC's failure to qualify under Rule 151 in holding its "Tax Deferred Investment Program" is a security. This is incorrect. Rule 151 was the most liberal of all the methods VALIC had available to it to attempt to turn its "Tax Deferred Investment Program" into an exempt insurance product. VALIC therefore insisted that the court should look to that Rule as the applicable criterion, not Release 6051, which was the governing standard for the time period involved in this case. Rule 151 represented, said VALIC, the current view of the SEC as to when a contract became a security, especially as to the investment risk factor.

VALIC was forced to confess that it could, at its unfettered discretion, change or eliminate the excess interest payable at any time—and therefore could not comply even with Rule 151's most liberal requirements. After VALIC admitted that it had misled the Court of Appeals and Otto, the court re-examined its conclusion. As a result, the court found that since VALIC could change the excess interest payable at any time, the investment risk shifted primarily on the investor. The court had indicated in its original opinion, in ruling for VALIC, that the call was close. Once VALIC was forced to reveal all the facts, the court found that VALIC no longer should prevail.

The Solicitor General claims that the court's second decision was decided "solely because the fixed annuity

did not satisfy one element of the test set forth in the Commission's Rule 151 . . ." SG Brief at p. 6. This is totally erroneous. The court's initial decision was not bottomed on Rule 151, but on the status of the contract under the securities laws. In its order of January 29, 1987 (Respondents' Brief in Opposition, App. 1), the Court of Appeals said:

> "If VALIC did, in fact, have the right to reduce the banded interest rates, our determination that the fixed annuity was an exempt insurance product not subject to the federal securities laws may be flawed. Whether VALIC possessed this discretion certainly is important to the level of investment risk assumed by VALIC. In addition, our opinion relied in part on the fixed annuity's satisfaction of all of Rule 151's 'safe harbor' requirements. One of those requirements apparently would not be met if VALIC had the authority to change the interest bands. The failure of the fixed annuity to qualify for safe harbor treatment under Rule 151 would not require us to find that the fixed annuity was a security, both because the Rule technically does not cover annuities for the time period in question *and because the rule does not purport to provide an all-inclusive definition of all annuities that are exempt from the federal securities laws.* Nevertheless, the failure of the fixed annuity to satisfy any prong of Rule 151 clearly is relevant to and requires a reevaluation of the status of the annuity." Respondent's Brief in Opposition, App. 5. (Emphasis added.)

As this language shows, the court did not rely entirely on Rule 151 for its decision. The court recognized that it had to examine the instrument under the broad rules of the securities acts, not just the narrow safe-harbor provisions. In its original opinion the court acknowledged that VALIC had come close to crossing the line. It said:

> "The difference between the plan before us and the one considered in *Peoria Union* [*Stock Yards Co. v. Penn Mutual Life Insurance Co.*, 698 F.2d 320 (7th Cir. 1983)] [where the product was held to be a security] is not enormous, but the balance of the investment risk has been sufficiently shifted to the insurance company to justify a different result here." *Otto v. VALIC*, 814 F.2d 1127, 1132 (7th Cir. 1987).

When VALIC was forced to admit that the investment risk was not what had been represented to the court, the court concluded that VALIC had therefore gone over the line. Said the court in its opinion on rehearing:

> "The amount of discretion retained by VALIC to alter the interest it paid under the fixed annuity is relevant to the level of the investment risk assumed by VALIC. As discussed in our previous opinion, the Supreme Court, this circuit and the Securities and Exchange Commission (the "SEC") all have found that the degree of investment risk assumed by the insurance company is an important factor in determining whether a particular annuity plan is an insurance product or a security." 814 F.2d at 1141.

The court then discussed *VALIC I* and *United Benefit*, along with the *Peoria Union* case and Rule 151. *Id.* The court concluded:

> "We find that on the facts of this case the minimum interest rates guaranteed under VALIC's fixed annuity plan, although they are somewhat in excess of those required by Rule 151, alone do not place the investment risk on VALIC sufficiently to exempt the plan from the federal securities laws. To find otherwise we would have to overlook entirely any requirement for a guarantee of excess interest. To do this would be to disregard completely one element contained in the investment risk test of the SEC's safe harbor Rule 151. Admittedly this is not an element relied on previously in court decisions distinguishing securities from insurance products. But it is an ele-

ment the SEC has insisted on over the objection of some commentators." *Id.* at 1142.

If any question still remains as to the role of Rule 151 in the court's reasoning—and its secondary importance —then the order amending the second opinion made this clear:

> "Because Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC. We do not say that Rule 151 defines the meaning of 'security'; it is a safe harbor rather than a definitional rule, as our first opinion observes, *see supra* at 1133 n.2. But VALIC's argument directly under the statute depends on its assertion that the guaranty of return here requires calling the instrument insurance under Sec. 3(a)(8) even if the prospect of 'excess' interest is a principal inducement to purchase this particular instrument. Because the contract actually leaves the investor with an investment risk significant enough to throw its status into doubt, VALIC's argument in this court effectively depended on its own analogy to the standards of Rule 151, which has not sufficed." *Id.*

There is nothing unclear about the court's decision and it conforms entirely with this Court's decisions in this area.

IV. Additional Grounds Exist Under The Securities Laws For Holding "The Tax Deferred Investment Program" To Be A Security

A number of additional grounds exist for finding the contract to be a security under the securities laws that were not discussed or responded to in the Solicitor General's Brief. These additional grounds are fully presented in Respondent's Brief in Opposition, were presented to the court below, and include the grounds that: the "fixed annuity" here is an option on a security, the variable annuity, and therefore is itself a security (SEC

Release 6558); and, that this case involves the "Tax Deferred Investment Program" at the "accumulation phase" of the contract, and not the annuity or "pay-out" phase (*United Benefit*). Both grounds independently support the result of the Court of Appeals' opinion, and support the denial of the petition for certiorari in the case.

CONCLUSION

As stated in Respondents' Brief in Opposition (pp. 15-18), this is a case of great importance only to VALIC and to the plaintiffs. At this stage the decision is interlocutory. Damages have not been assessed and numerous pleading and procedural issues are still outstanding. The need for certiorari is nonexistent. The Petition for Writ of Certiorari should be denied.

Respectfully submitted.

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No. 87-600

In the Supreme Court of the United States

OCTOBER TERM, 1987

VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, ETC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a contract written by a state-regulated insurance company may qualify under the "annuity contract" exemption to the Securities Act of 1933 if the contract guarantees the return of principal, guarantees payment of a fixed rate of interest, provides for the accrual of excess interest at rates set from time to time by the insurance company, and guarantees payment of any excess interest that accrues.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. Respondent Beverly Otto brought this class action in the United States District Court for the Northern District of Illinois against petitioners Variable Annuity Life Insurance Company (VALIC), affiliated companies, and certain of their officers and directors. VALIC is a Texas stock insurance company subject to state insurance regulation (Pet. App. 12a). Respondent Otto alleged that petitioners defrauded her and other class members in connection with their participation in VALIC's Tax Deferred Investment Program.[1] Otto contended that certain con-

[1] One of the features of VALIC's program was that Otto's contributions were excluded from her gross income pursuant to Section 403(b) of the Internal Revenue Code (26 U.S.C. (& Supp. III)).

tracts offered by VALIC under this program are securities subject to the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. 240.10b-5). C.A. App. D at 16-17.

The specific contract between Otto and VALIC was termed a "fixed annuity." Under the fixed-annuity contract, VALIC promised to pay Otto the amount of her contributions (less modest administrative charges), plus interest accumulated at a compound rate of 4% per year for the first ten years and 3-1/2% thereafter (Pet. App. 38a, 2a-3a). Otto's contributions were placed in VALIC's general account and invested primarily in long-term debt instruments such as mortgages and bonds (*id.* at 3a, 38a).[2] The contract also provided that VALIC, in its discretion, could credit "excess interest" over the guaranteed rate. VALIC promised to pay any monies that it declared and credited to Otto's account as excess interest (*ibid.*; C.A. App. K at 4). At the end of the contract term, Otto was entitled to withdraw the accumulated funds or use them to purchase an annuity from VALIC at specified rates (Pet. App. 2a-3a; C.A. App. K at 5). Otto also had the right to withdraw her money at any time before the end of the contract term (C.A. App. J at 5).

2. The district court granted petitioners' motion for summary judgment. The court held that VALIC's fixed-

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[2] VALIC also offers a variable-annuity contract that does not guarantee either the return of contributions or a rate of interest on contributions. VALIC's variable-annuity contract is registered as a security under the Securities Act of 1933, 15 U.S.C. 77a *et seq.* (Securities Act). Participants' contributions are placed into an account segregated from the company's general assets; the segregated account is registered as an investment company under the Investment Company Act of 1940, 15 U.S.C. (& Supp. IV) 80a-1 *et seq.* The value of a participant's variable account depends on the investment performance of the separate account portfolio (Pet. App. 38a).

annuity contract is not a security because it comes within the "annuity contract" exemption of Section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)) (Pet. App. 37a).[3] In so holding, the district court distinguished VALIC's fixed-annuity contract from the annuity contracts found to be securities in *SEC* v. *Variable Annuity Life Ins. Co. of America,* 359 U.S. 65 (1959) (*VALIC I*), and *SEC* v. *United Benefit Life Ins. Co.,* 387 U.S. 202 (1967). The district court concluded that, unlike the contracts in those cases, VALIC bore sufficient investment risk to qualify the contract under the Section 3(a)(8) exemption (Pet. App. 40a-41a).

3. The court of appeals initially affirmed. The court noted that, under VALIC's fixed annuity, participants were guaranteed a rate of return that "was not so low that * * * it placed the investment risk on the policyholder in a way substantial enough to make the fixed annuity a security" (Pet. App. 8a-9a). This conclusion, the court reasoned, was buttressed by recently promulgated Rule 151 of the Securities and Exchange Commission (the Commission) (17 C.F.R. 230.151). Rule 151 defines a "safe harbor" for entitlement to the "annuity contract" exemption (Pet. App. 10a).[4] Analyzing VALIC's fixed annuity under Rule

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[3] That provision exempts: "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia" (15 U.S.C. 77c(a)(8)). The district court held that an insurance policy or an annuity within the meaning of Section 3(a)(8) does not fall within the definition of "security" under both the Securities Act and the Securities Exchange Act of 1934, 15 U.S.C. (& Supp. IV) 78a *et seq.* (Pet. App. 36a-37a & n.1). Otto has not challenged this holding.

[4] Rule 151 specifies a three-prong test for determining whether a contract falls within the "safe harbor." The annuity contract must (a) be issued by a corporation subject to the supervision of the state in-

151, the court incorrectly assumed that VALIC guaranteed for the life of the contract the rate of any declared discretionary excess interest. The court believed that VALIC's fixed annuity therefore satisfied the requirement of Rule 151 that an issuer guarantee that it will not modify the rate of excess interest more often than once a year (Pet. App. 13a).

VALIC informed the court of appeals that it had the absolute right to change the excess interest rate at any time. After that fact was brought to the court's attention, the court issued an opinion holding that VALIC's fixed annuity contract is a security. The court stated: "A claimed right to change established excess interest rates and to eliminate excess interest payments entirely *at any time* surely tends to shift the investment risk from VALIC to the plan participant" (Pet. App. 30a (emphasis in original)). The court held that, although the minimum interest rates guaranteed by VALIC exceeded the rates required by Rule 151, this guarantee did not place sufficient investment risk on VALIC to qualify the contract for the "annuity contract" exemption of Section 3(a)(8). The court concluded that "[t]o find otherwise we would have to overlook *entirely* any requirement for a guarantee of excess interest. To do

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surance commissioner, bank commissioner, or any agency or officer performing like functions; (b) place sufficient investment risk on the issuer; and (c) not be marketed primarily as an investment. An issuer "shall be deemed to assume the investment risk" if (1) the value of the contract does not vary according to the investment experience of a separate account; (2) the contract guarantees the return of principal and interest credited thereto, and credits to net purchase payments and accrued interest a specified rate of interest at least equal to that required under the nonforfeiture law of the state in which the contract is issued or that set by the National Association of Insurance Commissioners; and (3) the issuer guarantees that any declared rate of excess interest will not be modified more frequently than once per year. 17 C.F.R. 230.151.

this would be to disregard completely one element contained in the investment risk test of the SEC's safe harbor Rule 151" (Pet. App. 31a (emphasis in original)).

DISCUSSION

This case presents an important issue concerning the definition of "security" under, and hence the reach of, the federal securities laws: whether a fixed-annuity contract that provides for discretionary excess interest and does not qualify for the "safe harbor" afforded by Rule 151 may nevertheless be exempt under Section 3(a)(8). We believe that the court of appeals' legal analysis is wrong. Accordingly, we believe that the Court should grant the petition for a writ of certiorari.

1. This case has caused great interest and concern in the insurance industry. The type of contract at issue here—a so-called fixed annuity with discretionary-interest features—is very common. An industry source states that, at the end of 1986, there were about 11 million such contracts in force nationwide. See American Council of Life Insurance, *1987 Life Insurance Fact Book Update* 16 (1987). This Court has not considered the "annuity contract" exemption since *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967). In the last 20 years, the insurance industry has marketed many new products that arguably fall within that exemption. These contracts are not all alike; thus this Court's decision will not necessarily resolve the application of the securities laws to all so-called fixed annuities. The Court's opinion could, however, provide valuable guidance to the lower courts and the industry as to the proper standards by which to judge these products.

The significance of this case is not limited to whether fraud claims will lie under Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)). If a fixed annuity with a discretionary-interest component is a security, it is subject

to the registration provisions of the Securities Act (15 U.S.C. 77e). Moreover, the insurance company and its agents must comply with the broker-dealer provisions of the Securities Exchange Act (15 U.S.C. (& Supp. IV) 78*o*), and the company may lose its "insurance company" exemption under the Investment Company Act of 1940 (15 U.S.C. (& Supp. IV) 80a-1 *et seq.*). For these reasons, we believe that this case warrants plenary review.

2. The reasoning of the court of appeals is unclear. The court's opinion on rehearing indicates that the court believed VALIC's fixed annuity failed to qualify as an "annuity contract" solely because the fixed annuity did not satisfy one element of the test set forth in the Commission's Rule 151—*i.e.*, that the excess-interest rate be guaranteed for at least one year. If that was the court's reasoning, it was mistaken. Rule 151 provides a "safe harbor" so that an issuer meeting the rule's criteria is reasonably assured that its contract falls within the statutory exemption. See Securities and Exchange Commission Release No. 33-6645, 51 Fed. Reg. 20254, 20254-20255 (1986). As a safe harbor, Rule 151 does not express the Commission's views on the outer limits of the exemption. Thus, an insurance company that offers "a contract that, for one reason or another, does not satisfy all of the rule's conditions may still rely directly on section 3(a)(8), albeit with no Commission assurance that the contract is covered by the section 3(a)(8) exclusion." 51 Fed. Reg. at 20255 (footnote omitted).

3. Whether VALIC's fixed annuity is an "annuity contract" within the meaning of Section 3(a)(8) should be answered by reference to *VALIC I* and *United Benefit*. Under those authorities—as well as the relevant announcements of the Commission—it is clear that the assumption of substantial "investment risk" by the insurance company is one crucial factor. See *United Benefit*,

387 U.S. at 211; *VALIC I,* 359 U.S. at 71; 51 Fed. Reg. at 20256. The relevant purpose of the securities laws is to ensure that investors in securities are fully and accurately informed about the issuer and the investment's relevant features, including its risks.[5] This protection is not needed if, inter alia, the insurance company assumes a sufficient share of the investment risk, which reduces the risk to the participant, who is also protected by state regulation of the insurance company. Even though the participant bears some degree of risk, the contract may qualify under the "annuity contract" exemption.[6]

VALIC assumed substantial investment risk under the fixed-annuity contract sold to Otto. VALIC guaranteed the return of principal; thus Otto and the class members did not bear the common investment risk that changes in the market will erode the investor's capital contributions. VALIC also guaranteed an interest rate of 3-1/2% or 4% on principal and accrued interest so that Otto knew that her contributions would produce some income. The value of Otto's account also did not vary according to the investment experience of a separate account. Moreover, VALIC

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[5] Justice Brennan noted in his concurring opinion in *VALIC I* that "[t]he prevention of insolvency and the maintenance of 'sound' financial condition in terms of fixed-dollar obligations [are] precisely what traditional state regulation is aimed at" (359 U.S. at 90-91). State regulation aims to assure that an insurance company will be able to meet its fixed-dollar obligations. Thus, a person who enters into a fixed-dollar contract with a regulated insurance company generally does not need the disclosures regarding an issuer's financial condition that are required by the Securities Act. Cf. *Marine Bank* v. *Weaver,* 455 U.S. 551, 558 (1982).

[6] *VALIC I* and *United Benefit* do not suggest that an issuer must assume *all* investment risk under a contract in order for the contract to come within the exemption.

guaranteed the payment of all monies it credited to her account (principal, interest, and excess interest) regardless of whether she surrendered the contract prior to the time when she could purchase an annuity. In other words, VALIC was bound to pay Otto the full value of her account whenever she decided to terminate her contract even if VALIC incurred costs in obtaining the necessary funds. Thus, under the terms of the contract, this important investment risk was not shifted to Otto if she surrendered the contract.[7]

Otto did have some investment risk under VALIC's fixed annuity. One of the fixed annuity's attractions undoubtedly was its excess-interest component. Indeed, the record shows that VALIC set a rate of 14-1/2% for deposits made in the third quarter of 1982. This rate was over ten points higher than the guaranteed minimum rate. Under the contract, Otto bore the risk that this excess-interest rate—or any other declared excess-interest rate—could be reduced or eliminated at VALIC's discretion.

Nonetheless, we believe that VALIC bore sufficient investment risk under the contract to meet the investment-risk criterion of Section 3(a)(8). The "annuity contract" exemption should not be limited to annuities with only guaranteed interest rates and no discretionary-interest component—a type of contact not commonly offered today. At least where, as here, a state-regulated insurer

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[7] By contrast, some contracts contain a "market value adjustment" (MVA) feature. Such a feature shifts investment risk to a participant who wishes to terminate the contract, by "discounting" account value according to a specified formula usually keyed to prevailing interest rates. The purpose of an MVA is to avoid or minimize loss by an issuer that has funded its obligations by investing in long-term debt instruments and would otherwise be required to sell those instruments at a discount to pay the participant his full account value.

assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the investment-risk criterion is satisfied.

4. Investment risk is only one of the interrelated criteria for judging whether a contract is an "annuity contract" under Section 3(a)(8). Another factor is the manner in which the contract is marketed. See *United Benefit,* 387 U.S. at 211. To qualify for the exemption, the insurance company's marketing plan must be aimed at appealing to purchasers " 'on the usual insurance basis of stability and security.' " 51 Fed. Reg. at 20261 (quoting *United Benefit,* 387 U.S. at 211). A contract most likely will not qualify under Section 3(a)(8) if it is marketed "with *primary* emphasis on current discretionary excess interest, and the possibility of future interest" rather than "the product's usefulness as a long-term insurance device for retirement or income security purposes." 51 Fed. Reg. at 20261 & n.47 (emphasis in original). We express no opinion whether the record in this case was adequate at the summary-judgment stage to allow the lower courts to assess VALIC's fixed annuity under this marketing criterion.

Another factor in a Section 3(a)(8) analysis is whether the insurance company assumes a meaningful mortality or longevity risk. See *VALIC I,* 359 U.S. at 71. At a minimum, to assume a mortality risk the insurance company must guarantee in the contract that the purchaser may buy an annuity at specified rates. The mortality risk is meaningful, however, only if there is a reasonable possibility that a purchaser reaching retirement age would choose to annuitize at those rates. VALIC's fixed-annuity contract guaranteed annuity rates for Otto when she retires between ages 50 and 75. The lower courts,

however, did not find whether this guarantee was meaningful. The lack of a meaningful mortality risk is not necessarily a disqualifying feature. See 51 Fed. Reg. at 20256. But if VALIC's marketing tactics place the status of its fixed-annuity contract in doubt, VALIC's assumption of a meaningful mortality risk might nonetheless tip the balance in favor of a conclusion that the contract is an "annuity contract" under Section 3(a)(8). Because the record may be incomplete on this factor, as well as on the marketing factor, we cannot state whether VALIC's fixed-annuity contract is exempt from the federal securities laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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No. 87-600

In The
Supreme Court of the United States
October Term, 1987

—o—

THE VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, RESPONDENT

—o—

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

—o—

MOTION FOR LEAVE TO FILE BRIEF FOR THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICUS CURIAE AND BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

—o—

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF FOR THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICUS CURIAE

Pursuant to Rule 36 of the Rules of this Court, the National Association of Life Companies ("NALC") requests leave to file the accompanying brief as *amicus curiae* in support of petitioners. Counsel for petitioners

has consented to the filing of this *amicus curiae* brief, but counsel for respondent has declined consent.

NALC is a nationwide trade association with a membership of 634 small and medium-sized life insurance companies. Small and medium-sized companies constitute 90% of the total number of life insurance companies in the country. NALC's member companies have in force more than $480 billion in insurance policies involving 68 million policyholders. These companies have in excess of $40 billion in aggregate assets and $13 billion in premium income.

A significant number of NALC's members issue excess interest fixed annuities like that of petitioner The Variable Annuity Life Insurance Company ("VALIC") that the court of appeals held to be a "security" for purposes of the federal securities laws. That decision is inconsistent with the common understanding in the industry that these policies are "insurance" and therefore not subject to the securities laws. Moreover, compliance with the various requirements of federal law would impose an especially heavy burden on small and medium-sized companies such as those that belong to NALC.

NALC believes that this *amicus curiae* brief will assist the Court in understanding the substantial public importance and practical consequences of the question presented in VALIC's petition. NALC has participated as *amicus curiae* in other federal cases to represent the interests of its members.

For the foregoing reasons, the motion of NALC for leave to file the accompanying brief as *amicus curiae* in support of petitioners should be granted.

Respectfully submitted.

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NOVEMBER 1987

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BRIEF FOR THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The National Association of Life Companies ("NALC") is a nationwide trade association of small and medium-sized insurance companies. Its interest in the question presented in this case is fully described in the

accompanying motion for leave to file this brief as *amicus curiae* in support of petitioners.

ARGUMENT

A. Excess Interest Fixed Annuities Are "Insurance" And Not "Securities."

As The Variable Annuity Life Insurance Company ("VALIC") demonstrates in its petition for certiorari, the excess interest fixed annuity at issue in this case has all of the features of the traditional fixed annuity that Congress intended to exclude from the federal securities laws: it contains a complete guarantee of all principal; it provides a guaranteed rate of interest for the life of the policy; its funds are included in the insurer's general assets and are invested in long-term debt-type instruments; it is sold on the usual insurance basis of stability and security and is designed to provide a long-term accumulation of retirement funds through compound interest; and it is extensively regulated by state insurance commissioners. Thus, the policyholder is guaranteed principal and a fixed rate of return regardless of the investment experience of the insurer or general economic conditions, and the company correspondingly bears a substantial investment risk.[1]

The court of appeals did not dispute these characteristics. Instead, it relied on the fact that VALIC's annuity

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1 The importance of these protections for policyholders and the role of fixed annuities in guarding against investment risks have been graphically illustrated by recent stock market events. See, e.g., Wall St. J., Oct. 22, 1987, at 37, col. 4.

also contained a discretionary excess interest provision that did not meet one of the requirements for "safe harbor" treatment under the Security and Exchange Commission's recently promulgated Rule 151.[2] But that does not change the essential nature of the instrument. While the possibility of a higher interest rate (at the discretion of the insurer) marginally shifts a part of the investment risk to the policyholder, the insurer retains a significant —indeed, the predominant—share of the risk. The cornerstone of the policy—the guarantee of principal and a specified return based on conservative long-term investment of the insurer's general assets pursuant to state insurance laws—establishes that the excess interest fixed annuity is an insurance product and not a security. Indeed, a number of recognized insurance products, such as participating dividend life insurance policies and universal life policies, resemble the excess interest provision because the return to the policyholder depends to some extent on the profits earned by the insurer.

For these reasons, the insurance industry has widely understood that excess interest fixed annuities constitute "insurance" exclusively regulated by the states and not "securities" subject to the federal securities laws. In fact, the decision below is the first to apply the securities laws to a fixed annuity. As we now show, that erroneous decision, if not reversed by this Court, will have substantial adverse consequences for the insurance industry.

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2 For the reasons stated in VALIC's petition, the court of appeals' application of Rule 151's "safe harbor" represents a serious misconstruction of an important provision of federal law that warrants this Court's review.

B. The Court Of Appeals' Erroneous Decision Will Substantially Affect The Insurance Industry.

If, contrary to the insurance industry's understanding, excess interest fixed annuities like VALIC's are securities for purposes of the federal securities laws, significant changes will be required in the way in which issuers of these policies conduct their business. Such changes will be disruptive and costly, especially for small and medium-sized insurance companies like NALC's members. At a minimum, the necessary changes will drive up the costs of these policies for consumers. In addition, the increased burden and expense may lead some issuers to withdraw from this market, thereby both restricting the availability of these policies to the public and reducing the diversity of policies that continue to be offered.

Moreover, the effects of the decision below will be immediate and widespread even though only one court of appeals has held excess interest fixed annuities to be securities. Companies that sell these annuities within the Seventh Circuit—and most fixed annuity issuers do—will at once have to comply with the court of appeals' decision by meeting the numerous requirements of the federal securities laws. Because, as a practical matter, compliance with many of these requirements cannot be confined to a particular geographical area, the ruling below will effectively have a nationwide impact.

NALC's concern about the expense and disruption that will result from the court of appeals' decision can be illustrated by two examples. If excess interest fixed annuities are securities, they are subject to the registration

and prospectus requirements in Sections 6-10 of the Securities Act of 1933, 15 U.S.C. §§ 77f-77j. By the same token, an issuer of securities registered under the 1933 Act also is required to file a number of public reports under Section 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*o*(d). Currently, however, excess interest fixed annuities do not have to be registered as securities and many issuers of these annuities are not otherwise covered by public reporting obligations. The novel application of these provisions to excess interest fixed annuities, as the court of appeals' decision would require, would impose substantial additional costs in the sale of such annuities.

In addition, if these fixed annuities are securities, the companies that issue them and the agents that sell them must register under the "broker/dealer" provisions of the federal securities laws. In contrast, under present law, insurance companies and their agents are required to be licensed only by state insurance commissioners pursuant to the standards established in each state. To meet the many conditions prescribed by federal law—including strict minimum capital criteria for the issuing company, stringent securities training and competency requirements for sales agents, and extensive recordkeeping obligations —would necessitate a fundamental change in business operations and would intrude upon the exclusive authority of state insurance regulators.

Compliance with the federal securities laws will be particularly onerous for small and medium-sized insurance companies. Because the costs of compliance generally are not a function of the volume of securities sold, smaller

companies issuing relatively fewer policies will bear a disproportionate burden in relation to the size of their annuity business. Beyond that, smaller companies typically are less familiar with the requirements of the federal securities laws and do not have large staffs of in-house counsel, thereby further increasing the practical burden of compliance.

Of course, if the federal securities laws dictate that excess interest fixed annuities be treated as securities, the costs of compliance will have to be borne by large and small companies alike. But until now, that has not been the ~~accepted~~ understanding of the scope of federal law. The insurance industry should not be forced to make major changes in its method of doing business unless this Court determines that such a drastic result is clearly required.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AND PROPOSED AMICUS CURIAE BRIEF OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE BY THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

The National Association of Insurance Commissioners ("NAIC"), as *amicus curiae*, respectfully requests this Court to grant leave for the filing of an *amicus* brief in support of the petition for certiorari to review the decision of the United States Court of Appeals for the Seventh Circuit, entered on April 15, 1987. Respondent was requested, but has failed, to consent to the filing of the brief which accompanies this motion. The Petitioner has consented to the filing of the brief.

Resolution of the issue in this case, that is the authority to regulate fixed annuity products, is of vital concern to all state insurance regulators. Although the merits of the application of the exemption under Section 3(a)(8) of the Securities Act of 1933 and the SEC Rule 151 safe harbor provisions are comprehensively briefed by the parties, the significance of the court of appeals' decision from the state insurance regulators' standpoint has not been fully expressed. Therefore, it is the NAIC's intention to demonstrate the impact and uncertainty caused by the court's decision on insurance regulators nationwide. The interest of the NAIC as *amicus curiae* is fully set forth at pages 3 and 4 of the attached brief.

The NAIC is not submitting this motion and proposed brief on the merits of the petitioners' position, but solely urges this Court to grant the writ of certiorari based on the regulatory implications created by the court of appeals' decision.

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BRIEF OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS AS AMICUS CURIAE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

INTEREST OF THE AMICUS CURIAE

The National Association of Insurance Commissioners ("NAIC") is a nonprofit, unincorporated association whose membership consists of the principal insurance regulatory officials of the 50 states, the District of Columbia, the

territories and insular possessions of the United States. The primary responsibility of the NAIC is to serve the public by assisting these regulators in overseeing the activities of the insurance industry.[1]

The interest of the NAIC in this case arises out of the regulatory responsibility vested in each state official over annuity products and the companies which sell them. This regulatory authority emanates from state law as well as federal law, the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015. The court of appeals' opinion impacts the traditional state regulatory approach to the sale of fixed annuities.

ARGUMENT

I. The court of appeals' decision holding that the fixed annuity constitutes a security significantly impacts the states' scheme for regulating annuities

As an association comprised of the country's principal insurance regulatory officials, the NAIC strives to achieve uniformity to the extent possible and also seeks to preserve state regulation of the business of insurance.[2]

Regulation of annuity products is an extensive nationwide effort. With the assistance of the NAIC, a comprehensive framework for state regulation of annuities has been established through the development of model laws and model regulations. Among the applicable models

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1. NAIC Constitution, article II, I *NAIC Proceedings* iii (1987).

2. *National Association of Insurance Commissioners Position Paper on Repeal or Modification of McCarran-Ferguson,* July, 1987.

which serve as the basis or prototype for the states' use are the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities (App. A, pp. A1-A2), the Model Annuity and Deposit Fund Disclosure Regulation (App. B, p. A3), the Model Rule (Regulation) for Recognizing a New Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities (App. C, p. A4), the Guideline Concerning the Commissioners' Reserve Valuation Method (CARVM) (App. D, p. A5), the Replacement of Life Insurance and Annuities Model Regulation (App. E, p. A6), and the Life and Health Insurance Guaranty Association Model Act (App. F, p. A7). A brief description of each model follows, along with the number of states which have adopted the models.

The NAIC Standard Nonforfeiture Law for Individual Deferred Annuities establishes a certain rate of interest to be assumed by the issuer. This NAIC model, adopted by 46 states, also sets forth the basis for calculating the reserves which are to be established for annuity contracts.

The purpose underlying the Model Annuity Deposit Fund Disclosure Regulation, which has been implemented by 9 states, is to assist consumers in purchasing an annuity which is suitable for their needs. It requires the delivery of certain information designed to accomplish this objective.

The Model Rule (Regulation) for Recognizing a New Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities was developed to determine the minimum standard of valuation for annuity and pure endowment contracts. It has been implemented by 41 states.

The CARVM was adopted by the NAIC in 1976 and was incorporated into the model standard valuation law. CARVM is now included in nearly all of the states' laws.

The Guideline Concerning the CARVM is intended to clarify certain interpretations of the CARVM which have developed over the years in practice.

The Replacement of Life Insurance and Annuities Model Regulation fulfills a consumer oriented objective in that it is designed to address sales and marketing aspects of annuities. In sixteen of the 42 states which have adopted this model, it applies to annuities.

The Life and Health Guaranty Association Model Act is the vehicle through which obligations under annuity contracts are fulfilled in the event of insurer insolvency. The model specifically covers fixed annuities, but excludes from coverage the portion of a contract in which risk is borne by the policyholder. Forty states have adopted this model.

Another significant NAIC model, although not specifically designed to address the sale of annuities, is commonly known as the Unfair Trade Practices Act which prohibits false advertising and misrepresentation, among other things, in the sale of all insurance policies and annuities.[3]

In addition to regulating the sale and other aspects of the annuity product itself, state officials generally oversee the activities of the insurers as well as their agents. Both an insurer's and an agent's authority to operate in a state are initially dependent on the issuance of a license by the insurance commissioner. The insurance departments exercise a number of other regulatory functions in addition to company licensing, including routine financial report-

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3. The official title of the NAIC Model is "An Act Relating to Unfair Methods of Competition and Unfair and Deceptive Acts and Practices in the Business of Insurance." *II NAIC Model Laws, Regulations and Guidelines*, p. 900.

ing, periodic financial examinations, market conduct examinations, supervision of advertising and marketing practices which are generally governed by unfair trade practices provisions, investment limitations, securities valuation, complaint handling, supervision of liquidations or rehabilitations and monitoring of state guaranty fund activity. With respect to agent activity beyond licensing, the states monitor sales practices, process complaints and provide a source of information to consumers. This brief overview of state regulation of annuities demonstrates that a coherent and consistent scheme is in effect.

A number of fixed annuity products sold today are similar to VALIC's in that they contain an "excess interest" component at a company's option in addition to a guaranteed rate of principal and interest. The sale of these products is exclusively governed by the state insurance laws and regulations described above. The precedent established in the court of appeals' decision could place an extensive portion of the annuities currently subject to state regulatory oversight under the control of federal securities laws. This potential for duplicative or conflicting regulation creates a degree of uncertainty for all insurance regulators. This uncertainty is complicated further by the possibility that similar challenges may occur in other jurisdictions which in turn present the possibility of conflicting results. Therefore, the uncertainty created and the possibility of conflicting circuit court opinions justifies a review of the court of appeals' decision.

II. The court of appeals' decision conflicts with basic principles of federalism

Federalism is an essential premise underlying state regulation of the business of insurance. This underlying

concept of federalism is based on traditional principles reflected in the Constitution.[4] The NAIC has previously stated that sound public policy supports the idea that ultimate decision-making power and responsibility should be dispersed rather than superimposing federal regulatory power over that of the state.[5]

The states' authority to regulate the business of insurance is a long-recognized tenet which was affirmatively established in the McCarran-Ferguson Act, 15 U.S.C. §§ 1012(a):

> The business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business.[6]

The McCarran-Ferguson Act provides further that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance." 15 U.S.C. § 1012(b).

The strong Congressional intent in favor of state regulation expressed in the McCarran-Ferguson Act was a reaffirmation of this same basic principle set forth in Section 3(a)(8) of the Securities Act of 1933 in which Congress specifically excluded insurance policies and annuity contracts from application of the federal securities

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4. *See* for example U.S. Const., art. I and IV. *See also* J. Hanson, *The Interplay of the Regimes of Antitrust Competition and State Insurance Regulation on the Business of Insurance,* Drake L. Rev. 767, 876 (1978-79).

5. Statement of the NAIC on Health Insurance before the House Committee on Ways and Means, I *NAIC Proceedings* 696, 702 (1972).

6. *See also SEC v. Variable Annuity Life Ins. Co.,* 359 U.S. 65 (1959).

laws. The court of appeals' decision affects this specific Congressional policy as well as the fundamental principle of federalism.

Given the effect that the court of appeals' opinion would have on Congressional intent and the complexity of the issues involved, the NAIC urges this Court to review the opinion.

SUMMARY OF ARGUMENT

The court of appeals' holding that the fixed annuity at issue constitutes a security subject to the federal securities laws significantly impacts state insurance regulators. Presently the sale of this product and similar products is governed exclusively by state insurance laws and regulations which have been developed and encouraged by the NAIC. The uncertainty created and the possibility of conflicting circuit court opinions on this complex issue in light of Congressional intent and principles of federalism warrants a review of that opinion.

CONCLUSION

The NAIC respectfully requests this Court to grant the petition for a writ of certiorari.

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December, 1987

APPENDIX

APPENDIX A

The NAIC Standard Nonforfeiture Law for Individual Deferred Annuities, or related legislation, has been adopted by the following states: Ala. Code § 27-15-28.1 (1984); Alaska Stat. § 21.45.305 (1978); Ariz. Rev. Stat. Ann. § 20-1232 (1977); Ark. Stat. Ann. § 66-3327.1 (1981); Cal. Ins. Code §§ 10168 to 10168.10 (1979); Colo. Rev. Stat. §§ 10-7-501 to 10-7-510 (1977); Conn. Gen. Stat. § 38-130d (1978); Del. Code Ann. tit. 18, § 2929A (1980); D.C. Code Ann. § 35-508 (1978); Ga. Code § 33-28-3 (1982); Hawaii Rev. Stat. § 431-564 (1979); Idaho Code § 41-1927A (1977); Ill. Rev. Stat. ch. I.C., § 229.4 (1980); Ind. Code §§ 27-1-12.5-1 to 27-1-12.5-10 (1977); Iowa Code § 508.38 (1981); Kan. Stat. Ann. § 40-428a (1978); Ky. Rev. Stat. § 304.15-315 (1978); La. Rev. Stat. Ann. § 22:173.1 (1979); Me. Rev. Stat. Ann. tit. 24-A, §§ 2541 to 2551 (1979); Md. Ann. Code art. 48A, § 408B (1980); Mass. Gen. Laws Ann. ch. 175, § 144A (1979); Mich. Comp. Laws § 500.4072 (1987); Minn. Stat. § 61A.245 (1979); Mont. Code Ann. §§ 33-20-501 to 33-20-513 (1979); Neb. Rev. Stat. §§ 44-407.10 to 44-407.23 (1979); Nev. Rev. Stat. §§ 688A.361 to 688A.369 (1979); N.H. Rev. Stat. Ann. §§ 409-A:1 to 409A:10 (1979); N.J. Rev. Stat. § 17B:25-20 (1981); N.M. Stat. Ann. § 59A-20-33 (1985); N.Y. Ins. Law § 4223 (1985); N.C. Gen. Stat. § 58-201.3 (1979); N.D. Cent. Code §§ 26.1-34-01 to 26.1-34-10 (1985); Ohio Rev. Code Ann. § 3915.073 (1983); Pa. Stat. Ann. tit. 40, § 37-116 (1980); S.C. Code Ann. §§ 38-8-10 to 38-8-120 (1978); S.D. Codified Laws Ann. §§ 58-15-72 to 58-15-81 (1977); Tenn. Code Ann. §§ 56-36-101 to 56-36-112 (1978); Tex. Ins. Code art.

3.44b (1977); Utah Code Ann. § 31A-22-409 (1986); Vt. Stat. Ann. tit. 8, § 3750 (1981); V.I. Code Ann. tit. 22 §§ 970 to 975 (1968); Va. Code §§ 38.2-3220 to 38.2-3229 (1986); Wash. Rev. Code Ann. § 48.23.360 (1973); W. Va. Code § 31-13-30a (1977); Wis. Stat. § 632.435 (1979); Wyo. Stat. §§ 26-16-401 to 26-16-411 (1983).

APPENDIX B

The NAIC Model Annuity and Deposit Fund Disclosure Regulation, or a related provision, has been implemented in these states: Md. Admin. Code tit. 9, Subtit. 30, ch. 28 § 01 to 07 (1980); Nev. Admin. Code §§ 688A.110 to 688A.180 (1980); N.H. Admin. Code Ins. 306.02 to 306.10 (1983); Pa. Admin. Code tit. 31 §§ 85.38 to 85.39 (1978); S.C. Ins. R. 69-39 (1986); Tenn. Admin. Comp. ch. 0780-1-17-.10 (1974); Tex. Admin. Code §§ 3.705 to 3.706 (1985); Wash. Admin. Code R. §§ 284-23-300 to 284-23-380 (1980); Wis. Admin. Code § Ins. 2.15 (1982).

APPENDIX C

The following states have implemented the NAIC Model Rule (Regulation) for Recognizing a New Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities, or a similar version: Ala. Ins. Dept. Reg. 76 (1985); Alaska Admin. Code tit. 3 §§ 28.600 to 28.690 (1985); Ariz. Ins. Order, Docket No. 5876 (1985); Ark. Ins. Rule & Reg. 38 (1985); Cal. Bulletin 85-14 (1985); Colo. Admin. Ins. Reg. 85-4 (1985); Conn. Admin. Code tit. 38, 130e-5 to 130e-9 (1985); Del. Ins. Reg. 53 (1985); Fla. Admin. Code §§ 4-71.001 to 4-71.004 (1985); Ga. Admin. Comp. ch. 120-2-39-.01 (1987); Idaho Ins. Reg. 46 (1985); Ill. Admin. Reg. tit. 50 § 935 (1985); Ind. Admin. tit. 760, R. 1-35 (1985); Iowa Admin. Code §§ 191-43.1 to 191-43.5 (1985); Kan. Admin. Regs. § 40-2-18 (1986); 806 Ky. Admin. Regs. 6:070 § 4(3) (1985); La. Ins. Rule 8 (1985); Me. Ins. Reg. ch. 340 (1985); Md. Admin. Code tit. 9, Subtit. 30, ch. 68 (1985); Mich. Admin. Code R. 500.1291 (1984); Miss. Ins. Reg. 84-105 (1985); Mo. Admin. Code tit. 4 § 190-13.270 (1986); Neb. Admin. R. tit. 210, ch. 42 (1985); N.H. Admin. Code Ins. 307.01 to 307.05 (1985); N.J. Admin. Code § 11:4-26.5 (1985); N.M. Ins. Regs. Art. 20 Rule 5 (1985) [SCC-85-22]; N.Y. Admin. Code tit. 11 §§ 58.0 to 58.6 (Reg. 117) (1984); N.C. Admin. Code tit. 11 ch. 11F §§ .0007 to 0010 (1985); N.D. Admin. Code § 45-04-08 (1986); Okla. Ins. Regs. Part VI, Rule 36-15-1 (1985); Or. Admin. R. 836-51-101 to 836-51-105, 836-51-120 (1985); Pa. Admin. Code tit. 31 § 84.3 to 84.4 (1986); S.C. Ins. R. 69-37 (1984); Tenn. Admin. Comp. ch. 0780-1-52 (1985); Tex. Admin. Code §§ 3.1501 to 3.1505 (1985); Utah Ins. R540-96 (1985); Vt. Admin. Comp. Ins. Dept. R. I-85-2 (Part A) (1985); Va. Ins. Reg. 27 (1985); Wash. Admin. Code R. 284-74-010 (1987); Wis. Admin. Code § Ins. 2.30 (1985); Wyo. Ins. Regs. ch. XVII (1985).

APPENDIX D

The CARVM guideline generally is observed on an informal basis. It is not implemented by the states through statutes or regulation. Therefore, a list of states which have adopted the guideline is unavailable. However, the NAIC is aware that nearly all state laws include the CARVM itself.

APPENDIX E

The Replacement of Life Insurance and Annuities Model Regulation or a similar version has been adopted by these states and is applicable to annuities: Colo. Admin. Ins. Reg. 82-1 (1982); Del. Ins. Reg. 30 (amended 1984); Idaho Ins. Regs. 41 (1983); Iowa Admin. Code §§ 510-16.1 to 510-16.10 (1984); Md. Admin. Code tit. 9 subtit. 30 ch. 31 §§ .01 to .11 (1985); Mo. Admin. Code tit. 4 § 190-13.060 (1983); Neb. Admin. R. tit. 210 ch. 19 (amended) (1984); N.C. Admin. Code tit. 11 ch. 12 §§ .0601 to .0611 (1985); Pa. Admin. Code tit. 31 §§ 81.1 to 81.9 (1986); P.R.R. Rule ILII (1957); S.C. Ins. R. 69-12.1 (1986); Tenn. Admin. Comp. ch. 0780-1-24 (1985); Vt. Admin. Comp. Ins. Dept. R. 87-2 (1987); Wash. Admin. Code R. §§ 284-23-400 to 284-23-530 (1987); Wis. Admin. Code § Ins. 2.07 (1982); Wyo. Ins. Regs. ch. XII (1986).

APPENDIX F

The following states have adopted the Life and Health Insurance Guaranty Association Model Act or related legislation: Ala. Code §§ 27-44-1 to 27-44-21 (1982); Ariz. Rev. Stat. Ann. §§ 20-681 to 20-695 (1977); Conn. Gen. Stat. §§ 38-301 to 38-318 (1985); Del. Code Ann. tit. 18 §§ 4401 to 4419 (1986); Fla. Stat. §§ 631.711 to 631.735 (1987); Ga. Code §§ 33-38-1 to 33-38-21 (1981); Hawaii Rev. Stat. §§ 431F-1 to 431F-18 (1979); Idaho Code §§ 41-4301 to 41-4319 (1987); Ill. Rev. Stat. ch. I.C., §§ 531.01 to 531.19 (1986); Ind. Code §§ 27-8-8-1 to 27-8-8-18 (1986); Kan. Stat. Ann. §§ 40-3001 to 40-3018 (1986); Ky. Rev. Stat. §§ 304.42.010 to 304.42.190 (1978); Me. Rev. Stat. Ann. tit. 24-A, §§ 4601 to 4618 (1985); Mo. Ann. Code art. 48A, §§ 520 to 537 (1985); Mass. Gen. Laws ch. 175 § 146B (1987); Mich. Comp. Laws §§ 500.7701 to 500.7780 (1982); Minn. Stat. §§ 61B.01 to 61B.16 (1984); Miss. Code Ann. 83-23-201 to 83-23-235 (1985); Mont. Code Ann. §§ 33-10-201 to 33-10-230 (1987); Neb. Rev. Stat. §§ 44-2701 to 44-2720 (1986); Nev. Rev. Stat. §§ 686C.010 to 686C.370 (1987); N.H. Rev. Stat. Ann. §§ 404-D:1 to 404-D:18 (1971); N.M. Stat. Ann. §§ 59A-42-1 to 59A-42-16 (1985); N.Y. Ins. Laws §§ 7501 to 7507 (1987); N.C. Gen. Stat. §§ 58-155.65 to 58-155.84 (1973); N.D. Cent. Code §§ 26.1-38-01 to 26.1-38-16 (1987); Okla. Stat. tit. 36 §§ 2021 to 2043 (1987); Or. Rev. Stat. §§ 734.750 to 734.890 (1975); Pa. Stat. Ann. tit. 40 §§ 41-101 to 41-123 (1979); P.R. Laws Ann. tit. 26, §§ 3901 to 3918 (1980); R.I. Gen. Laws §§ 27-34.1-1 to 27-34.1-20 (1985); S.C. Code Ann. §§ 38-17-10 to 38-17-190 (1980); Tex. Ins. Code art. 21.28-D (1987), see also: Tex. Ins. Code art. 21-28-E; Utah Code Ann. §§ 31A-28-101 to 31A-28-119 (1987); Vt. Stat. Ann.

tit. 8 §§ 4151 to 4169 (1972); Va. Code §§ 38.2-1700 to 38.2-1721 (1987); Wash. Rev. Code §§ 48.32A.010 to 48.32A.930 (1971); W. Va. Code §§ 33-26A-1 to 33-26-18 (1977); Wis. Stat. §§ 646.01 to 646.73 (1986).

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DEC 14 1987

No. 87-600

In The
Supreme Court of the United States
October Term, 1987

The Variable Annuity Life Insurance Company, et al.,

Petitioners

v.

Beverly J. Otto, individually and on behalf of all others similarly situated,

Respondent

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF FOR THE ASSOCIATION OF CALIFORNIA LIFE INSURANCE COMPANIES AS AMICUS CURIAE AND BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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MOTION OF THE ASSOCIATION OF CALIFORNIA LIFE INSURANCE COMPANIES FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

Pursuant to Rule 36 of the Rules of this Court, the Association of California Life Insurance Companies ("ACLIC") respectfully requests leave to file the accompanying brief as *amicus curiae* in support of peti-

tioners. Counsel for petitioners has consented to the filing of this *amicus curiae* brief. Counsel for respondent has declined consent.

ACLIC is a nonprofit trade association whose members are domestic California life insurance companies and foreign life insurance companies which do business in California. The membership list of ACLIC is set forth in Appendix A to the attached brief. One of the primary purposes of ACLIC is to represent the interests of its members and their policyholders in substantial public policy matters which affect them. ACLIC has participated as *amicus curiae* in other federal cases for this purpose.

ACLIC members include both large and small companies representing an asset base of over $23 billion in domestic California companies and over $714 billion in foreign companies doing business in California.[1] ACLIC has a duty to promote the solvency of its members and the soundness of the products they issue, including the soundness of the excess interest rates paid by the various companies. In the instant case, ACLIC has a substantial interest in insuring that the definition of an annuity in section 3(a)(8) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77c(a)(8), is not so restricted as to exclude the traditional fixed annuity with excess interest. Such a restriction would inject confusion, expense and multiple regulation into established principles and methods of insurance regulation, investment management, product design and annuity distribution.

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[1] Association of California Life Insurance Companies, *California Life Insurance Fact Book—1985* (1986), citing California Department of Insurance statistics.

The fixed annuity product involved in this action is commonly used for retirement funding, often by teachers or other public employees. The market for fixed annuity sales is highly competitive. Purchasing decisions often depend upon narrow rate comparisons. The decision below threatens the existing competitive market by adding dual and unnecessary regulation and attendant expense, by restricting rate competition and by making insurance agents ineligible to sell fixed annuities unless they are also registered representatives of registered "broker/dealer" principals.

The dollar volume of fixed annuity business issued by ACLIC members and affected by the *Otto* decision is immense. In 1986, a total of 10.5 million people nationwide were covered by annuity plans, of which 6.1 million were fixed annuities.[2] It is typically estimated that 10% of the annuity purchasers reside in California. In 1978, 22 insurance companies domiciled in California held a total of $3 billion in assets, of which annuities represented 13% or $389 million. Annuities had grown at an annual compound rate of 15.7% over the prior five years, as compared to 9.2% for assets overall.[3] According to ACLIC records for 1986, the total annuity consideration and annuity and other fund deposits of ACLIC members totaled over $2.5 billion. Fixed annuities make up virtually all of the annuity business in California. If the *Otto* decision is allowed to stand, federal securities requirements will be

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[2] American Council of Life Insurance, *Life Insurance Fact Book—1986* (1986).

[3] Association of California Life Insurance Companies, *Taxation of the Life Insurance Industry in California*, 13 (1981).

superimposed on these annuity contracts, in addition to the existing system of state regulation.

ACLIC is familiar with the questions involved in the case and the scope of their presentation. ACLIC believes that additional argument should be presented on the broader consequences of the decision below. While petitioner has fully analyzed and briefed the legal issues presented, additional briefing by ACLIC will assist the Court by demonstrating the adverse practical and economic consequences of the decision below.

It is therefore respectfully requested that the motion of ACLIC for leave to file the attached brief as *amicus curiae* be granted.

Respectfully submitted,

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December 1987

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BRIEF OF THE ASSOCIATION OF CALIFORNIA LIFE INSURANCE COMPANIES AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The Association of California Insurance Companies ("ACLIC") is a trade association comprised of domestic California insurance companies and foreign insurance

companies doing business in California. Its interest in the question presented in this case is fully described in the motion for leave to file this brief as *amicus curiae* in support of petitioners.

BACKGROUND

The type of insurance contract involved in this action is a group fixed annuity with additional "excess interest". The question presented in this case is whether such a contract is an "annuity" under federal law and regulated by the states, or a "security" and regulated by the United States Securities and Exchange Commission ("SEC"). An annuity, of course, is an agreement to pay a determinable sum of money at a future date or for a period of time, usually actuarially determined or tied to the life span of the annuitant. From the standpoint of the issuer, an annuity entails an interest assumption as to what income can be generated with the purchase consideration or premiums, as well as a mortality assumption as to the longevity of the annuitant which will govern the total annuity benefit to be paid out over a period of years.

Annuities can be either single premium, where all consideration is paid at the outset, or periodic, where the consideration is paid over a period of months or years, often by payroll withholding. Annuities may be regarded as having an accumulation phase, in which the annuity consideration is accrued, and a distribution phase, in which the annuity proceeds are disbursed according to the form of annuity benefit chosen by the annuitant. The annuity value consists of the premium payments plus a return thereon. In a fixed annuity, the return is at a specified

rate of interest, while in a variable annuity, the return depends upon the gain (or loss) on a given investment fund.

In a variable annuity, the risk of losing both the purchase consideration and the income thereon is borne by the purchaser, based on the market performance of the underlying investment fund. Therefore, variable annuities have long been treated as securities for regulatory purposes.

Conversely, a fixed annuity "excess interest" contract routinely entails a guarantee of the full sum of the purchase consideration, the accrual and guarantee of a basic fixed rate of interest, and the accrual and vesting of additional "excess interest" at rates announced prospectively at specified intervals. It should be clearly recognized that the purchaser of a fixed annuity with discretionary "excess interest" is not at risk of losing either principal or accrued interest, basic or excess. The only risk to the purchaser is that the prospective excess interest rate will be changed or eliminated after the current period for which it has been announced.

A final significant characteristic of a fixed annuity is that the purchaser can withdraw the accumulated premium payments and accrued interest at any time, often without withdrawal or surrender charge. Thus, the issuer of a fixed annuity always bears the risks of maintaining unimpaired the accumulated premium payments and of producing the basic rate of interest and any announced rate of "excess interest", while the purchaser can always withdraw if the prospective rate of "excess interest" is not satisfactory.

The Court of Appeals in this case took a landmark stand of great importance which extends beyond the narrow facts presented. On the continuum of insurance products currently available in California, ACLIC believes the excess interest fixed annuity comes closest to the classic nonparticipating fixed annuity without excess interest. The Seventh Circuit opinion holds that any annuity not meeting the "safe harbor" of SEC Rule 151, 17 C.F.R. § 230.151, 51 Fed. Reg. 20,254 (June 4, 1986), does not qualify for exemption from securities regulation under Section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. § 77c(a)(8)). Since variable annuities are already classed as securities, the decision below effectively means that most commonly available annuities will now be treated as securities. In effect, the Seventh Circuit has read out of Section 3(a)(8) of the 1933 Act any exemption of annuities or optional annuity contracts.

The annuity in question here, like most fixed annuities sold in California, does not come within the safe harbor test because the discretionary "excess interest" is subject to prospective change more frequently than once per year. Other insurance products are functionally similar to the Otto annuity with respect to interest declarations. For example, participating contracts, on which the issuer declares retrospective dividends, would not fit under a safe harbor test like Rule 151 because the dividend rate is not guaranteed or even declared until operating results are known. Also, life insurance contracts typically include benefit payment options which provide for the crediting of discretionary "excess interest".[4] Thus, the

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[4] Life Management Institute, Life Office Management Association, *Principles of Life and Health Insurance*, 147-152 (1984).

Seventh Circuit's decision may portend the extension of federal securities regulation to all life insurance contracts. The absence of clear guidance under the securities laws creates uncertainty as to the regulatory treatment of these products, which are highly similar to fixed annuities in the level of mortality and investment risk placed on the insurer.

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REASONS FOR GRANTING THE PETITION

1. THE ERRONEOUS DECISION BY THE SEVENTH CIRCUIT UPSETS WIDESPREAD RELIANCE ON PREVIOUS PRECEDENTS AND THREATENS TO ENGULF MANY OTHER INSURANCE PRODUCTS.

This case represents the first time a court has held that a fixed/excess interest annuity contract is a security. This holding erroneously reasons that failure to qualify under a safe harbor rule is tantamount to failure to qualify for the exemption at all, thus shrinking the exemption to the narrower confines of the safe harbor. This precipitous expansion of federal securities regulation is based solely on the frequency of declaration of discretionary benefits which may only enhance the value of the contract, but cannot decrease it. Not only does this case represent an important failure of statutory interpretation in the construction of Section 3(a)(8), but this holding also throws new doubt on the status of all comparable insurance contracts. In that regard, most policies issued by mutual insurance companies—traditionally the largest share of the market—and many by stock insurance com-

panies provide for participation in the financial success of the insurer. Such participation is realized in the declaration of dividends. Dividends are functionally identical to discretionary interest on fixed annuities in that both are vested for the period declared but uncertain for other, future periods. Since fixed annuities resemble other common insurance products, the decision below presents the specter of possible expansion of its holding to other insurance products. This threat is exacerbated by the uncertain reasoning of the Seventh Circuit. Only enunciation of an informed rule by this Court will prevent pervasive disruption of the regulatory, disclosure and distribution systems in place for fixed annuities in every state, including California.

In its initial opinion, Appendix A to the petition for writ of certiorari ("petition"), the Seventh Circuit accepted Section 3(a)(8) of the 1933 Act as a general exemptive rule. The court compared the *Otto* annuity to a variable annuity, a deferred or "optional" annuity plan and a group deposit administration contract as analyzed in prior cases, and concluded that the *Otto* annuity was not a security. This result was reached before addressing Rule 151 or any requirement of guaranteeing the duration of the rate of excess interest.[5] This conclusion did not rest on, but was only "supported by", Rule 151.[6] Noting the guaranteed rates of 4% and 3½% in the *Otto* contract, the

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[5] Appendix A, petition, 8a to 9a, citing *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959), *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), and *Peoria Union Stock Yards Co. v. Penn Mutual Life Ins. Co.*, 698 F.2d 320 (7th Cir. 1983), respectively.

[6] Appendix A, petition, 10a.

court concluded that the rate of return was "not so low that we can say it placed the investment risk on the policyholder in a way substantial enough to make the fixed annuity a security."[7]

In the Seventh Circuit's second and third opinions, Appendices B and C to the petition, the court never identified any risk supposedly assumed by the policyholder which might justify the court's change of opinion that the contract was a security under Section 3(a)(8). As set forth above, the only possible risk of loss to the fixed annuity purchaser is that future prospective "excess interest" declarations will be at a lower level. It is specious to describe the fixed annuity purchaser as at risk when the risk is one which the purchaser can decline to accept. Since the annuity purchaser is free to withdraw his funds, including accumulated earnings, the purchaser's risk is hardly comparable to that of a typical securities investor, whose capital and accumulated income may be eroded by market conditions and totally unavailable for withdrawal. Moreover, this so-called risk of a fixed annuity purchaser is functionally identical to that faced by the owner of any participating insurance contract—that the future dividend declarations will be at a lower rate. Indeed, the owner of a medically underwritten insurance contract will often have less mobility because health and age changes may prevent replacing the coverage through another insurer offering greater dividend rates. Thus, not only has the Seventh Circuit conferred security status on an instrument which places all significant risks on the issuer, not the purchaser, but it

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[7] *Id.*

has also done so with murky logic which could include numerous other insurance products.

Finally, the Seventh Circuit said in its second opinion (and did not alter the statement in its final opinion) that the court could not "overlook entirely any requirement for a guarantee of excess interest."[8] Despite the fact that countless product design, investment and marketing decisions had been based on existing case precedents, the court admitted that "this is not an element relied on previously in court decisions distinguishing securities from insurance products."[9] The Seventh Circuit narrowed the boundaries of the exemption to make them co-extensive with the safe harbor by finding that VALIC's reservation of the right to prospectively change the quarterly "excess interest" rate automatically made the contract a security. The Seventh Circuit position thus denies insurers the prerogative to issue annuities exempt under past interpretations of Section 3(a)(8), yet not meeting the narrow safe harbor test.

2. THE SEVENTH CIRCUIT DECISION IMPOSES FEDERAL REGULATION FOR EXERCISING NECESSARY RATE FLEXIBILITY AND INTRUDES ON AN AREA ALREADY COMPETENTLY REGULATED BY THE STATES.

The only respect in which the *Otto* annuity fails the safe harbor test is in permitting the issuer to adjust excess rates more frequently than once per year. The ability to

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8 Appendix B, petition, 31a.

9 *Id.*

adjust rates frequently is critical to the solvency of insurers and to protecting the financial welfare of their policyholders. If rates are effectively required to be adjusted only infrequently in order to avoid costly and duplicative federal regulation, both insurers and their customers will suffer. If the insurer makes exceedingly cautious prospective rate decisions to provide a cushion against uncertain future market conditions, the purchaser's return will be reduced but without the purchaser receiving any additional benefit. If the insured throws caution to the winds and offers a high, long-term guaranteed rate, it courts insolvency to itself, loss and inconvenience to its policyholders and, through the mechanism of state insurance guarantee funds, similar losses to other insurers and their policyholders. The losses may occur through risky investment gambles made to fund the high rates, through ordinary market fluctuations, or by redemption calls on high-yield bonds purchased to sustain the necessary returns.

In order to prevent erosion of the mandates of the McCarran-Ferguson Act, 15 U.S.C. Sections 1011, *et seq.*, and Section 3(a)(8) of the 1933 Act, regulation should be left to the states where, as in this case, the public interest in securities regulation of a particular contract is not strong. There is no strong public policy interest in federal securities regulation of the exact interest crediting policies of insurers closely regulated under state law, as long as the policies retain the guarantees of principal, accrued basic and excess interest and future interest, to the extent declared by the insurer.

The McCarran-Ferguson Act established the basic principle that insurance regulation is best left to the

states. The Securities Act of 1933, 15 U.S.C. Section 77c (a)(8), continues this approach by broadly excluding from securities regulation "[a]ny insurance or endowment policy or annuity contract or optional annuity contract." The 1933 Act imposed needed regulatory controls on an economic sector which had operated without them to the peril of the national economy. As Congress recognized, there is, however, no such regulatory vacuum in the case of insurance and annuities.

Each state has its own insurance regulatory framework, with interstate coordination achieved through uniform laws drafted by the National Association of Insurance Commissioners ("NAIC"). This coordinated regulatory framework governs the accumulation of insurance company reserves, identifies the type of investment insurers may make, sets additional reserves for contracts shifting risk to policyholders, and imposes other limitations on interest crediting policies. For example, in California, an insurer may not issue annuity contracts or other insurance products providing "investment return assurance", until it has "satisfied the commissioner that its condition or method of operation in connection with the issuance of certain policies shall not be such as to render its operation hazardous to the public, or its policyholders . . .".[10] Such insurer must also meet capital and surplus requirements which are not demanded of other insurers.

State reserve calculation rules also influence interest crediting policies. California has adopted the "floating rate" method of reserve calculation, which is recommended

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10 California Insurance Code, § 10507.

in the NAIC Model Act (1987).[11] This method sets reserve requirements according to a formula based on the duration of the annuity contract and permits annuity returns to float above a minimum guaranteed rate according to a specified index, instead of using basic and excess interest rates. The imposition of federal securities regulation as the sole alternative to long-term fixed rate guarantees will effectively stifle state experimentation with innovative methods of rate calculation, to the potential detriment of the annuity-purchasing public.

It should be recognized that insurance companies are especially vulnerable to huge losses based on small fluctuations in regulatory or market conditions. Their sheer size creates inertia and their portfolios are ordinarily long-term, at least in part due to capital and reserve requirements imposed by state law. Moreover, insurers typically operate on a small margin or yield. Surpluses tend to be small as a fraction of liabilities or total assets, Domestic California companies have a combined capital and/or surplus of $2.4 billion on total liabilities and reserves of $20.8 billion and total assets of $23 billion.[12] Every major economic or regulatory development threatens insurance companies with catastrophic losses if they are locked into aggressive financial positions. Historically, the industry has suffered severe losses and insolvencies when investment yields fell below guaranteed contract rates. For example, in 1923, the net interest rate earned on life insurance investments was 5.18 percent and guaranteed rates

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[11] California Insurance Code § 10489.4 (as amended 1981).

[12] Association of California Life Insurance Companies, *California Life Insurance Fact Book—1985* (1986), citing California Department of Insurance 1984 statistics.

of 3.5 or even 4 percent were common.[13] By 1947, the net interest rate earned declined to a low of 2.88 percent, below the average guaranteed rate on all policies outstanding for some insurers, with obvious consequences.[14]

Generally, annuities like the *Otto* policy contain basic interest rate guarantees that are effective for terms as long as thirty or fifty years, at the policyholder's option. Conservative assumptions must be used in setting basic rate guarantees to prevent losses and insolvencies in the event of widespread market rate declines. Conservative investment policies may follow to assure achievement of the rate assumptions. In California and most other states, insurers are required to invest primarily in long and medium term bonds and in real estate.[15] Comparability with other retirement funding methods and prevention of disintermediation of funds out of insurance vehicles can best be achieved by discretionary "excess interest" declarations.

The Rule 151 one year guarantee period is simply too long for some policies. A sharp rise in interest rates as occurred in the last decade, with prime rates rising from 8% to 15%, could not have been predicted or compensated for if rates were guaranteed for one year. Such sharp rises in market rates, without the ability to adjust rates by annuity issuers, cause disintermediation. Many policyowners surrender policies to take advantage of other vehicles unless the annuity issuer can keep pace. A sharp

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13 Mehr, *Life Insurance Theory and Practice, 664* (1977).

14 *Id.*

15 See California Insurance Code §§ 1150 *et seq.*

drop in rates spurs issuers to call the bonds in which insurers invest, forcing insurers to reinvest in lower-paying vehicles. Unless crediting rates can be adjusted downward, large losses will occur. Insurers must have the ability to adjust interest crediting rates in periods of rapidly changing market interest rates, both to protect themselves and to fairly compensate their annuity buyers.

In both its first and second opinions, the Seventh Circuit relied upon the principles set forth by this Court in *SEC v. Variable Annuity Life Ins. Co.*, that insurance "involves some investment risk-taking on the part of the company" and "a guarantee that at least some fraction of the benefits will be payable in fixed amounts."[16] The fixed annuity with discretionary interest meets the test of *SEC v. VALIC.* The insurer not only guarantees benefits based on the stated basic rate and the underlying mortality assumption, but also guarantees the excess interest credited each quarter. Unlike the issuer of a variable annuity, the issuer of a fixed/excess interest annuity bears essentially all of the investment risk.

A similar form of fixed/excess interest annuity was considered in *Olpin v. Ideal National Insurance Company.*[17] The Tenth Circuit found that a fixed annuity with a discretionary dividend payment, which the policyowner did not control and which was not guaranteed at all, was not a security. This result was based on the finding that the insurers "bore the entire risk that they might not realize

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16 359 U.S. 65 at 71 (1959).

17 419 F.2d 1250 (10th Cir. 1969), *cert. denied,* 397 U.S. 1074 (1970).

from the investment'' the promised bonus sums.[18] The fixed/excess interest annuity is not, therefore, a security.

3. IN THIS CASE, THE BENEFITS OF FEDERAL REGULATION DO NOT OUTWEIGH THE COSTS OF IMMEDIATE, PERVASIVE DISRUPTION OF EXISTING REGULATORY AND DISTRIBUTION SYSTEMS DEVELOPED BY THE STATES.

In this case, the benefits of federal regulation do not outweigh the costs of disrupting or duplicating regulatory and distribution systems already in place. Currently, group fixed pension plan annuity contracts are sold in the same manner as group life insurance contracts, typically by life insurance agents who are not NASD registered representatives. They are sold in connection with retirement plans, often employee benefit plans which are themselves regulated under federal law.[19] Under the Seventh Circuit's opinion, this sales force would become ineligible to market a basic retirement funding instrument. According to California Department of Insurance statistics, there are more than 85,000 life insurance salespeople in California alone, of whom only a very small fraction are NASD registered. None of them could sell an *Otto* annuity until they became registered. Approximately 60 to 90 days is typically required to educate, test and qualify a registered representative, assuming ''broker/dealer'' administrative systems are available and functioning.

In addition, fixed annuity sales people typically operate under the purview of an independent brokerage, general

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[18] 419 F.2d 1261.

[19] See Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001 *et seq.* and Internal Revenue Code 26 U.S.C. § 403 (b).

agency or company-owned district office. These entities are typically not registered principal "broker/dealers" and would be ineligible to sponsor the sale of fixed/excess interest annuities held to be securities until registration could be achieved. Further delay in restoring a legally qualified sales force for this class of annuity would inevitably result.

The issuers of the annuities would likewise require reorganization under the Seventh Circuit's holding. Either the entire general account of each issuer would become subject to SEC accounting, reporting and disclosure requirements or separate investment company subsidiaries would be formed. Either approach would be time-consuming and expensive.

Finally, expense and further delay would be entailed in the preparation of registration statements and in allowing the same to become effective.

Each of these securities regulation functions is substantially duplicated in existing state insurance regulation. In California, agents are required to be trained, tested and licensed by the Department of Insurance.[20] Brokerages, general agencies, and district offices are required to be operated by state-licensed personnel.[21] Insurers may not operate in California until they are admitted to do so, again by the Department of Insurance.[22] Insurers are required to achieve minimum capitalization and reserves and are suspended from writing insurance

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20 California Insurance Code §§ 1631, 1645.

21 California Insurance Code § 1627.

22 California Insurance Code § 700.

if such minimums are not maintained.[23] Insurer investments are regulated and restricted, with emphasis on real property, governmental obligations and corporate bonds.[24] Insurer operations are audited by the Department of Insurance and detailed annual financial reports are required to be filed for public inspection.[25] Finally, the California Department of Insurance liquidates insolvent insurance companies, calling upon the insurer-financed guarantee fund to satisfy policy owner claims and upon other insurers to assume continuing contractual obligations.[26]

The drafters of the 1933 Act recognized that the business of insurance should not be considered static; this Court enunciated in *SEC v. Variable Life Ins. Co., supra,* that the courts should not "freeze the concepts of 'insurance' and 'annuity' into the mold they fitted when the Federal [Securities] Acts were passed."[27] Allowing flexibility in annuity contract design without impairing the basic fixed annuity guarantees of principal and accrued interest does not call for classification as a security.

In summary, the Court is urged to recall the caution of *SEC v. Variable Annuity Life Ins. Co., supra,* at 68, to act "with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements". Indeed,

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23 California Insurance Code §§ 1153, 1153.5.

24 California Insurance Code §§ 1150 *et seq.*

25 California Insurance Code §§ 734, 900.

26 California Insurance Code §§ 1011, 1016, 1063 *et seq.*

27 359 U.S. at 71.

allowing a wider range of annuity types allows healthy competition among insurers, gives annuity purchasers a diverse selection and permits the states simultaneously to examine different and potentially desirable annuity designs. Requiring all policies to meet the narrow confines of Rule 151 would impair this process. Moreover, the Court is urged to delineate annuity products legitimately serving the purposes of stability and guarantee inherent in insurance separately from variable products which serve the purposes of investment; and, for insurance and annuities, to continue the combination of diversity and protection which characterizes state insurance regulation.

———o———

CONCLUSION

The petition for a writ of certiorari should be granted.

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December, 1987

APPENDIX A

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Acacia Mutual Life Insurance Company
Alexander Hamilton Life
Allstate Life Insurance Company
Anchor National Life Insurance Company
Beneficial Standard Life Insurance Company
BEST Life Assurance Company of California
Blue Cross of California
Cal-Farm Life Insurance Company
California-Western States Life Insurance Company
Certified Life Insurance Company
CIGNA Companies
CNA Insurance Companies
Commercial Bankers Life Insurance Company
Crown Life Insurance Company
The Equitable Life Assurance Society
Executive Life Insurance Company
First Capital Life Insurance Company
Golden State Mutual Life Insurance
Great American Life Insurance Company
Lincoln National Corporation
Metropolitan Life Insurance Company
New England Mutual Life Insurance Company
New York Life Insurance Company
Pacific Mutual (Pacific Financial Companies)
Phoenix Mutual Life Insurance Company
Pierce National Life Insurance Company
Provident Life and Accident Insurance Company
The Prudential Insurance Company of America

Sovereign Life Insurance Company of California
Standard Insurance Company
Transamerica Occidental Life Insurance Company
Union Labor Life Insurance Company
United Insurance Company of America
UNUM Life Insurance Company
West Coast Life Insurance Company

MOTION FILED
DEC 16 1987

No. 87-600

In the Supreme Court of the United States

OCTOBER TERM, 1987

THE VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF FOR THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATIONS AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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MOTION FOR LEAVE TO FILE BRIEF FOR THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATIONS AS AMICUS CURIAE

Pursuant to Rule 36 of the Rules of this Court, the National Organization of Life and Health Insurance Guaranty Associations ("NOLHGA") requests leave to file the accompanying brief as *amicus curiae* in support of petitioners. Counsel for petitioners has consented to the filing of this *amicus curiae* brief, but counsel for respondent has declined consent.

NOLHGA consists of all of the operating life and health insurance guaranty associations that have been established by state laws enacted in 40 states, including Illinois and Texas. An insurance guaranty association assumes the insurance obligations of insolvent or financially impaired insurance companies. By ensuring the

payment of benefits and the continuation of coverage for policyholders, NOLHGA's members guarantee essential health benefits and retirement income for millions of people.

The ability of state guaranty associations to protect consumers of insurance will be substantially and adversely affected by the decision that petitioner The Variable Annuity Life Insurance Company ("VALIC") asks this Court to review. The holding of the court of appeals that the excess interest fixed annuity issued by VALIC was a security under the federal securities laws increases the prospect of insurance company insolvencies and at the same time threatens to harm the ability of guaranty associations to pay the claims of an insolvent insurer's policyholders.

Accordingly, NOLHGA submits this brief to explain the substantial practical importance to guaranty associations, and to the policyholding public they protect, of the question presented in VALIC's petition for certiorari. NOLHGA has participated as *amicus curiae* in other judicial proceedings to represent the interests of its member associations.

For the foregoing reasons, the motion of NOLHGA for leave to file the accompanying brief as *amicus curiae* in support of petitioners should be granted.

Respectfully submitted.

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TABLE OF AUTHORITIES

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§§ 5(9), 9 5

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BRIEF FOR THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATIONS AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The National Organization of Life and Health Insurance Guaranty Associations ("NOLHGA") consists of all of the life and health insurance guaranty associations that have been established under state statutes enacted in 40 states. NOLHGA's interest in the question presented here is set forth in the accompanying motion for leave to file this brief as *amicus curiae* in support of petitioners.

ARGUMENT

THE DECISION OF THE COURT OF APPEALS THREATENS TO INJURE CONSUMERS OF INSURANCE BY IMPAIRING THE OPERATIONS OF STATE GUARANTY ASSOCIATIONS

For the reasons stated in the petition for certiorari, NOLHGA agrees that the decision of the court of appeals in this case is both important and erroneous. Of particular concern to NOLHGA is that the decision may adversely affect the ability of state life and health insurance guaranty associations to protect consumers of insurance—the very group that the court of appeals sought to protect.

A. Operations of State Guaranty Associations.

The insurance codes of 40 states, including Illinois and Texas, provide for an insurance guaranty association to pay benefits and continue the coverage for insurance and annuity policyholders of financially troubled insurers. This guaranty system safeguards the interest of insurance consumers by assuring them that, subject to statutory limits, the vital protections they have purchased will remain in force despite a failure in the financial condition of the issuing company. In this way, state insurance guaranty associations reinforce the long-term safety and reliability of insurance products.

The life and health insurance guaranty association in each state is composed of all insurers that write life or health insurance or annuities in the state. If a member company becomes insolvent, the association is required to guarantee, assume, or reinsure all of the member's contracts that are covered by the guaranty statute and to assure payment of all covered claims of the member's policyholders. In addition, the guaranty association may

guarantee, assume, or reinsure contracts, or pay claims, if a member company becomes financially "impaired." The association funds the obligations it assumes from insolvent or impaired insurers primarily by assessments levied on its other member insurance companies.

B. Guaranty Coverage Will Be Adversely Affected.

The state statutes prescribing the duties and powers of guaranty associations are derived from one of three versions of the Model Life and Health Insurance Guaranty Association Act ("Model Act") adopted by the National Association of Insurance Commissioners ("NAIC"). Each of these versions provides that the Model Act "shall not apply" to any "part" or "portion" of a life insurance or annuity policy "under which the risk is borne by" the policyholder; the two later versions also make specific provision that the Act does not apply to any portion of a variable policy "not guaranteed" by the insurer. See Model Act § 3, 1986 NAIC Model Regulation Svce. 520-1, 520-2; 1977 NAIC Model Regulation Svce. 520-1, 520-2; 1 NAIC Proceedings 160, 161 (1971).

NOLHGA is unaware of any judicial authority construing this language. However, the court of appeals' decision raises serious questions of whether this "risk" limitation would affect coverage under the state statutes of excess interest fixed annuities as well as other interest-sensitive annuity and life insurance products, because a security is generally understood to be an instrument the value of which is not "guaranteed," and under which "the risk is borne" by the contract holder. At the least, there is a substantial possibility that the excess interest portion of the contract (including, potentially, accrued excess interest payments that have been declared and credited to the policyholders) would be removed from the statutory guaranty. By depriving policyholders of guaranty protections that both the insurance industry and consumers have heretofore understood to be applicable,

the Seventh Circuit's decision will be detrimental to the interest of policyholders in being assured that their insurance and annuity benefits will be available if and when they are needed. To give policyholders that peace of mind is the fundamental purpose of insurance.

The dangers posed to policyholders by a financially impaired or insolvent insurer are well illustrated by the recent example of the insurance subsidiaries of the Baldwin United Corporation, which when it became insolvent in 1983 was the largest insolvency in U.S. history. If even a portion of the interest credited to holders of Baldwin's single premium deferred annuities had fallen outside the state guaranty statutes, on the ground that the risk under these interest sensitive "securities" was borne by the policyholder, approximately 167,000 annuity holders would have lost substantial guaranty protections of accumulated interest.

C. Insolvency Risks Could Be Increased.

The decision of the court of appeals also could have other adverse consequences for insurance guaranty programs and policyholders. As explained in the petition (at 12-13), issuers of excess interest fixed annuities would be exposed to liability for damages and to rescission of the contracts (with a refund for premiums paid) under the federal securities laws. If such unanticipated liabilities occur, they could lead to the insolvency or impairment of insurers and thereby impose an additional burden on guaranty associations. Moreover, rescission of outstanding contracts would skew the actuarial and mortality assumptions that underlie an insurer's portfolio of policies; this would be especially problematic, and would further threaten the financial health of insurance companies, because policyholders who decide to retain their policies rather than seek rescission are likely to be worse insurance risks and therefore disproportionately costly to the insurer.

D. Guaranty Associations' Assessment Ability May Be Impaired.

In addition, if a contract is excluded (in whole or in part) from the guaranty statute, the attendant premiums would not be included in the member insurance company's base on which the guaranty association makes assessments to fund the insurance obligations it assumes. *See* Model Act §§ 5(9), 9 (assessments are based on member premiums for covered contracts). The Seventh Circuit's ruling thus introduces a significant uncertainty over the proper assessment base and raises the possibility that guaranty associations would face a substantially diminished ability to pay claims. This concern would be exacerbated to the extent that insurance companies could seek a refund of assessments already paid on the ground that the premium base included contracts that, under the court of appeals' decision, were securities and not insurance covered by the guaranty statute.

In sum, NOLHGA submits that the decision of the court of appeals in this case represents a threat to the proper functioning of its member state guaranty associations and to the interests of policyholders that the guaranty statutes are intended to protect. Those disturbing consequences demonstrate the need for this Court to review and reverse the ruling below.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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BEVERLY J. OTTO, INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED,
Respondent

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE AMERICAN COUNCIL OF LIFE INSURANCE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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Respondent

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE AMERICAN COUNCIL OF LIFE INSURANCE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Pursuant to Rule 36.1 of the Rules of the United States Supreme Court, the American Council of Life Insurance ("Council") respectfully moves this Court for leave to file the attached brief as *amicus curiae* in this case. Counsel for petitioner The Variably Annuity Life Insurance Company ("VALIC") has consented to the filing of the brief. Counsel for the respondent Beverely J. Otto ("Otto") has declined to consent.

The Council has a membership of 646 life insurance companies whose aggregate assets account for approximately 94% of the assets of all United States life insurance companies and 97% of the assets of retirement plans funded through life insurance companies. Most fixed-dollar annuity contracts and some forms of fixed-dollar life insurance (e.g., universal life insurance) contain guarantees of principal and interest and "excess interest" features that have varying degrees of similarity to the guaranteed and excess interest provisions of the fixed annuity contract which was issued by VALIC and held to be a security by the court of appeals. These contracts represent a significant portion of the aggregate life insurance and annuity business in force in the United States today. As of year-end 1986, there were approximately 11 million fixed-dollar individual annuities in force involving present and deferred annual annuity payments of $27 billion. American Council of Life Insurance, *1987 Life Insurance Fact Book Update* at 16 (1987). The Council estimates that, for the same period, there were approximately 38 million persons covered under private pension plans funded by group fixed-dollar annuity contracts. Annual payments into these plans were approximately $36 billion and actual payments made from such plans during the year totaled almost $12 billion. *Id.* at 25. Also as of year-end 1986, there were approximately 11 million universal life insurance policies in force, representing over $864 billion of insurance. *Id.* at 14.

The Council has a substantial interest in this case because the decision below has created considerable uncertainty for its member companies with respect to the applicability of the federal securities laws to fixed-dollar annuity and insurance contracts, and has given rise to serious concerns about the financial health of insurance companies, the interests of consumers, and the continuing availability of life insurance and annuity products.

The Council was permitted (over the objection of Otto) to file a brief as *amicus curiae* in support of VALIC's request for rehearing *en banc* in the court of appeals. The Council has also participated as *amicus curiae* in other federal court proceedings of significance to the life insurance industry.

In light of the fact that respondent's brief in opposition is not due until December 16, respondent will have adequate opportunity to respond to any points raised in the attached brief.

CONCLUSION

For the reasons set forth above and in the attached brief, the Council requests that this Court grant its motion for leave to file the attached brief as *amicus curiae.*

Respectfully submitted,

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